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Secretariat for Analysis of
Swedish Development Assistance

Foreign Aid and Macroeconomic Development in Guinea-Bissau

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SASDA

Secretariat for Analysis of Swedish Development Assistance

The Swedish government has appointed a committee with the task of analysing the results and effectiveness of Swedish development aid. A special Secretariat, SASDA, was set up on 1 March 1993 to carry out the work.

The Secretariat will work until the end of 1994 and will have as its main task to propose to Government suitable mechanisms for evaluations and policy analyses of Swedish aid. In its work SASDA will give priority to carrying out a set of of selected studies world-wide, at country, sector and subject level and to studies of individual organisations to provide a basis for decisions on development co-operation in the future and to gain experience on how policy evaluations should be carried out. A major study concerns Sweden's co-operation with Central and Eastern Europe.

SASDA's point of departure is the aim of a better understanding of the mechanisms of development in order to enhance the results and increase the effectiveness of aid in achieving the five goals set by the Swedish parliament: increased resources, economic and social equality, economic and political independence, the democratic development of society, and the long-term management of natural resources and care of the environment.

The studies and analyses will be managed partly by the Secretariat's own staff and will include studies commissioned from different specialists in the committee's areas of priority.

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You must manage the best you can.

LEWIS CARROLL, *Alice's Adventures in Wonderland*

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TABLE OF CONTENTS

FOREIGN AID AND MACROECONOMIC DEVELOPMENT IN GUINEA-BISSAU

CHAPTER I

INTRODUCTION

There is a long tradition of microeconomic evaluations of aid-financed development projects, but the recent years have witnessed an increasing concern for aid effectiveness in a more aggregate sense. Aid is intended to promote economic development and growth: yet, relatively few empirical studies have focused on the effects of aid inflows on overall economic performance. The present study examines the macroeconomic effects of foreign aid on Guinea-Bissau. The analysis is based on an accounting framework presented by White (1994), and aims to identify relationships between aid inflows and selected macroeconomic aggregates appearing in the country's balance of payments and national accounts. The objective is to trace the impact of aid on the country's internal and external balances, which include variables like imports, exports, investments, and savings. Another objective is to provide some recommendations regarding Swedish aid to Guinea-Bissau.

The empirical parts of the study concentrate on events during the period between 1987 and 1992, which is the only period for which accurate and consistent data are available. This short time perspective limits the possibilities to make far-reaching generalizations about effects of aid, but the lack of consistent historical data precludes any other approach. Hence, it should be noted already at the outset that our conclusions apply to the period after the mid-1980s. The character of available data dictates other limitations as well. For instance, our analysis is based on data covering the formal sector of Guinea-Bissau. We know that there is also a large informal sector, the size of which is estimated to a third of official GDP (Correia Sá, 1994) but there is no quantitative information on the activities taking place in the sector[1]. The decision to emphasize aggregate effects and macroeconomic variables determines some additional restrictions. In the subsequent analysis, we will not provide detailed discussions of how Swedish aid resources have been used, nor will we examine the performance or impact of specific aid projects.

Guinea-Bissau is, in many respects, a peculiar country. It is among the least developed in the world, and its per capita incomes, capital stocks, living standards, and levels of education are among the lowest in the world. Industrial development is extremely limited, and the country's production structure is narrow even in African terms. At the same time, poverty is fairly evenly spread among the population, and hunger is seldom encountered. Chapter II presents a brief description of Guinea-Bissau, as a background for the discussion in the remainder of the study.

The Republic of Guinea-Bissau was established in 1974 after a long liberation war against Portugal. The period under colonial rule, as Portuguese Guinea, had created a dual economic structure which was taken over by the socialist government that was installed after Independence. An inefficient public sector controlled the formal economy with rules, regulations, and administratively fixed prices, while the majority of the population belonged to an informal sector that was neither controlled, taxed, nor measured by official authorities. The duality and the lack of market institutions inhibited economic development during the first decade after Independence, but the development strategy - and with it, economic policies - have changed markedly since the mid-1980s. At that time, Guinea-Bissau, with the support of the World Bank and other donors, launched a comprehensive structural transformation program that involves economic liberalization, macroeconomic stabilization, and the creation of institutions for economic development. Some aspects of this transformation process have been successful, whereas others have

1 Correia Sá (1994) does not provide detailed information about how the size of the informal sector has been estimated.

been impeded by the lack of an appropriate institutional framework and shortages of technical and managerial skills. Chapter III provides an overview of Guinea-Bissau's economic policies since Independence.

Chapter IV focuses on the impact of aid on macroeconomic aggregates. The analysis is based on the accounting framework introduced by White (1994), and concentrates on the period 1987-1992. The short data series means that it is not very useful to employ traditional statistical techniques to establish relationships between aid and the other variables, so the analysis is conducted in a less formal manner. Data limitations also mean that some potentially important phenomena cannot be discussed at all. For instance, analyses of the monetary impact of aid and counterpart funds or the effects of counterpart funds on fiscal behavior are not possible. The reason is that the counterpart funds for some significant donations have been frozen, and that data on flows (but not stocks) of other counterpart funds are available only for 1990-1991. Similarly, it would be valuable to examine the effects of aid on social welfare, income distribution, and environmental issues, but the data are missing and we have chosen not to enter into speculations that cannot be supported by tangible evidence.

Chapter V summarizes the findings of the study, and draws some conclusions regarding the level and structure of Swedish aid to Guinea-Bissau.

CHAPTER II

COUNTRY PROFILE

The Republic of Guinea-Bissau was established in 1974 after a long national liberation war against Portugal led by the PAIGC (*Partido Africano da Independência de Guiné e Cabo Verde*). Guinea-Bissau is a small West African nation of approximately 36,000 square km and a population of 1 million. It borders to Senegal in the north and to Guinea-Conacry in the south and the east. Its eastern part touches to the Sahel area, with the climatic zone rapidly changing to a densely vegetated southwestern part.

The population comprises several ethnic groups, that are divided by language and religion. Islam dominates the eastern and northern parts of the country, and accounts for 30 percent of the population, while the remaining part is considered to be animistic, except for some 5 percent who are Christian. Creole, a mixture of Portuguese and local languages, is the *lingua franca* and is spoken by 60 to 70 percent of the population. The official language is Portuguese, which is used in the administration and taught in schools.

Guinea-Bissau is among the poorest countries in the world. Poverty is fairly evenly spread among the population, although there is a small middle class stratum. Nevertheless, hunger is seldom encountered.

Primary Production

Agriculture is the most important activity, and accounts for about 50 percent of GDP, 75 percent of exports and 80 to 90 percent of total employment. The most common production unit is the rural family, but in recent years small plantations, particularly of cashew trees, have increased in number and importance. The basic social unit in the family sector is the *tabanca*, a village consisting of 100 to 1,000 individuals from the same ethnic group.

There is a commercial agricultural sector, the *ponteiro* sector, which accounts for about 10 percent of farm output. There are some 1,100 *ponteiro* farms or *pontas*. The *ponta* lands are worked by wage labor and are individually registered, as opposed to *tabanca* lands which are owned collectively by the village. The number of *pontas* has increased in number and size after 1986, often at the expense of the land that traditionally belonged to the ethnic groups in the *tabancas*[2]. A few *ponteiros* have started producing off-season vegetables and fruits for the Portuguese and other European markets.

Rice, the main food product, is grown on one third of the cultivated area. It is mainly produced in the south and northwest, but self-sufficiency has not been regained after the liberation war, which destroyed much of the production infrastructure. Rain-fed cereals, as millet, sorghum and corn, cover another third of the cultivated area, while the rest is divided between cashew, palm trees and groundnuts.

A surplus of rice is produced in the south of the country, around Catió, by farmers using traditional, human-powered production systems. Production is mainly in the form of polder (*bolanha*) rice. The collection of rice from farmers is handled by approximately 100 merchants who are coordinated by two or three wholesale merchants. Most rice processing is still done manually, by women, but increasing numbers of small rice husking machines have been installed lately, financed mainly by donors. There is another rice center around Bafatá (in the northwest) where a large scale rice husking factory has been installed. The institutional environment for rice marketing has improved significantly during recent years

2 Aguilar and Zejan (1991).

and policies have become more supportive of of private sector initiative. Road barriers that used to interrupt transport between regions have been abolished. Fees and customs procedures that used to impede shipping from Catió have disappeared. The major remaining deficiencies are a lack of operating capital and inefficiencies related to the collection of rice from many small-scale producers in the south[3]. The prospects for expanding *bolanha* rice output depend mainly on the possibilities to clear and prepare new land for cultivation. Reclaiming mangrove areas is very labor intensive and full yields are only realized after five to six years. The major constraint is the low profitability of rice cultivation, which means that it is difficult to attract labor. In the short run, this means that increased output can mainly be obtained in already reclaimed areas. Existing agricultural practices, however, are difficult to improve. The present production methods are well-tuned, improved over hundreds of years, and a breakthrough in the use of fertilizer is unlikely, given the subsistence orientation of production and the lack of extension, credit and input delivery systems. Upland rice is usually grown in cleared forest areas as part of a slash-and-burn cultivation pattern. The scope of expansion, in this case, depends on the extent to which deforestation can and should be allowed to continue[4].

Cultivation of cashew trees has grown in importance during the last decade, both for export revenues and cash incomes for rural families, while palm products and groundnuts have lost importance in terms of exports, due to low world market prices. Since there has been a rush to establish land rights since the Structural Adjustment Program (SAP) was launched in 1987, *ponteiros* and *tabancas* have planted part of their lands with cashew trees to signal possession. Still, in many cases, little resources are invested in the cultivation of the cashew trees, which are not pruned. The production of juice from the cashew apple, which is normally allowed to ferment into wine, is also important for the cashew producers. Cashew harvesting is done by women, who are also the ones who produce and sell the juice and wine. The main restrictions to cashew expansion are the capacity of the domestic market to absorb juice and wine, and the willingness of producers to move into a somewhat more advanced system, which would entail more managerial inputs and some cash expenses[5].

Fishing contributes to foreign exchange earnings through licenses granted by the public sector to foreign fishing fleets. Although fishing resources are abundant, there has not been any significant development of domestic fishing or related industries. Foreign fishing

3 FFGI (1992).
4 FAO-IC (1993), p. 3-8.
5 FAO-IC (1993), p.10.

activities have no linkages with domestic activities, since the foreign fleets seldom land their catches in Guinea-Bissau. Small scale fishing is very limited, both in techniques and importance. It is mainly on the Bijagos islands where the population can be argued to depend on fishing, but even there much of the local fishing is done by seasonally migrating fishermen from neighboring countries.

Timber and forestry have became increasingly important for foreign exchange revenues. For some rural households, the production of charcoal constitutes an important complementary income source. The exploitation of forest resources and the widespread use of slash-and-burn techniques have led to deforestation of parts of the country and subsequent problems with land degradation. This has caused seasonal or permanent migration, in particular from the eastern to the southern parts of the country, in search of more fertile land.

Guinea-Bissau has very few other natural resources, although there has been some prospecting of bauxite in the eastern parts. The physical and economic infrastructure of the country does not allow for any extensive exploration of these resources. The hydroelectric potential is considered to be quite substantial, as there are several rivers of which at least one has the necessary falling height. Again, the supportive infrastructure, physical as well as human, is likely to be insufficient.

The possibilities to establish off-shore oil production have been considered since the late 1950s, but no drilling ever has taken place, although some American companies have acquired the exploration rights. Presently, the low world market price of oil makes off-shore extraction non-profitable.

Industry and Infrastructure

During the years immediately after Independence, resources were concentrated to large industrial projects, that were not suited to the country´s conditions. Some examples are a car factory that assembled Citroën-motors and locally-produced chassis, a beer brewery and a groundnut oil processing plant. These plants were over-dimensioned and hardly adapted to local needs and capacity. As a result, they never generated any profits, but required heavy subsidies from government funds. Most installations were closed down during the 1980s. Traditional and local manufacturing were generally constrained by lack of inputs and funds. Later on, as development aid picked up (in particular the extensive

rural development programs), many of the local craftsmen, especially blacksmiths and makers of simple tools, were put out of business. Lately, some more selective investments in fairly heavy facilities have resumed. For example, a rice husking factory has been installed in Bafatá, the groundnut oil factory is supposed to restart with new funds from foreign sources, and many small initiatives are supported by development aid funds.

The supply of infrastructural services, electricity, water supply and sewage, and transportation networks in Guinea-Bissau is inadequate. The road network comprised 2,636 km. in 1987, but only 15 percent were in good condition. The road transport industry faces many problems, like poor road conditions, weak financial performance of transport companies, and weak organization of freight transport. With the recovery of Guinea-Bissau's economy since 1986-1987, and the increased availability of foreign exchange, there have been some improvements. For instance, there has been an increase in the number of privately-owned minibuses that now provide acceptable intercity services, connecting Bissau to the most important urban centers. Some major road upgrading projects have been initiated and led to substantial reductions in transportation time. A new road to the southern part of the country has been constructed. This is particularly important since the southern region is considered as an important development area and the main potential source for domestically produced rice surpluses. Feeder roads and the links to river transport, however, still need to be improved in order to support agricultural development.

Trade and Markets

Guinean exports are dominated by a few primary products and its foreign exchange earnings are therefore highly dependent on a volatile world market for agricultural goods. Imports comprise mainly consumer goods and intermediates. In the last years, the country has imported large amounts of rice, which is considered to be detrimental to domestic production. There are several reasons for these large rice imports. For instance, Guinea-Bissau has low tariffs for rice, so rice is imported and then smuggled to neighboring countries where prices are higher due to tariffs. Cheap imported rice is also used in barter transactions to acquire cashew nuts, which command higher prices in the world market.

The large traditional rural sector, the *tabanca* sector, consists of between 85,000 and 90,000 small farms. In most cases, the male head of the family is responsible for providing the staples for family consumption, while the women are engaged in petty trading and production to generate cash incomes. Although the main activity is subsistence farming, a high proportion of households sell part of their crops in the market and participate actively in local commerce. Rice is the main subsistence crop and other subsistence cereals are maize, sorghum and millet. Savings are mainly in tangibles, such as livestock. Recent studies indicate that most transactions in the countryside are monetary, which contradicts the common assumption that barter is prevalent. In regions close to the country´s borders, transactions in foreign currencies are more frequent, while barter is common in some of the areas where cashew nuts are produced, since these are traditionally exchanged for rice[6].

The local markets have for a long time been closely connected with those of neighboring countries, in particular Senegal. Trade is mainly undertaken by small scale ambulating traders, the *djilas*, and migrating guineans. Smuggling is supposedly quite substantial and foreign exchange holdings are commonplace among the local population.

Private activity is constrained by lack of infrastructure, management, skilled labor and credit. The lack of appropriate credit instruments and institutions is considered to be one of the major bottlenecks, both in the development of small scale production firms and in agricultural transformation. Credit has been administered by the state and offered at negative real interest rates. In spite of donor priorities, no sustainable system of rural credit has been established. Informal credit seems to be targeted for emergency needs rather than for long-term investments. Creditors are mainly family and local money lenders or traders, and credits are often given in kind.

Aid and Foreign Debt

Ever since Independence, the formal economy has largely depended on foreign aid and credits. The sources of foreign assistance have been numerous, reaching from the former Eastern bloc, with mainly military assistance, to Western countries, of which Sweden and the Netherlands have been major donors, and to international organizations, such as the World Bank, the IMF, the African Development Bank and OPEC. At an aggregate level, aid has largely been allocated according to the national development strategy, with the main part going to large projects during the 1970s and early 1980s, and thereafter focusing more on support to the economic and administrative reforms. However, the allocation of

6 See Alvesson (1992).

funds at the project level seems to have suffered from lack of feasibility studies, project appraisal, and monitoring. Technical assistance has always made up a significant share of incoming foreign assistance.

Guinea-Bissau is one of the most indebted countries in the world, in terms of the ratio of debt to national income. At the end of 1992, total outstanding debt amounted to 296 percent of GNP and the country had accumulated arrears equivalent to 80 percent of GNP. Approximately half of the debt is owed to multilateral agencies. Most of the debt stock originates from the period after Independence, and in recent years the debt has increased at an accelerating rate. In 1992, the scheduled debt service ratio (interest payments and amortizations) amounted to 258 percent of the exports earnings, which was of course untenable. Actual debt service payments were limited to 14 percent of exports, i.e. roughly a twentieth of the scheduled amounts. It is obvious that the huge debt is a serious obstacle for sustainable development since it imposes severe limits to the use of fiscal resources. Future development programs that do not include substantial debt reductions and rescheduling are not likely to be feasible.

Social Sectors

The annual average population growth fell from 4.7 percent during the 1970s to 1.9 percent during the 1980s, which is low in comparison with other Sub-Saharan African countries. Life expectancy at birth is the lowest in the world, 39 years, which mainly is caused by an infant mortality rate of 148 per thousand. The most serious health problem is malaria, which in combination with malnutrition and anemia, pose a threat to the health standards of the population. HIV is frequent (between 8 to 14 percent of the population) and increasing at a high rate[7].

At Independence, most of the rural population was left outside the public health care system[8]. A National Health Policy was formulated in 1976, and primary health care was considered the most important priority for rural areas. Between 1979 and 1989, the number of Village Health Units covering small villages increased from 14 to 536[9]. Also the number of midwives and basic health workers increased in number. In later years, due to low

7 WB (1990), p. 7.
8 Galli and Jones (1897), p. 177.
9 WB (1990), p. 5.

salaries, lack of recurrent training of the personnel, poor management, and an increasing shortage of medicines, the services offered by the primary health care system have been eroded. Table 2.1 provides information about some health indicators in Guinea-Bissau and neighboring countries.

The health sector is almost totally dependent on donor funds. Only 7.5 percent of public investment in the health sector in 1990 was financed by the government. Since the mid-1980s, the government has allocated a relatively small share of current fiscal expenditures to the health sector: 7.6 percent of the budget in 1986 and 7 percent in 1990, with decreasing amounts in constant PG[10]. As a result, salaries have fallen in real terms, diverting nurses and other personnel from their profession and discouraging new recruitment. In combination with the lack of medicines, this has led to doubts about the public sector's capacity to solve basic health problems.

The level of education in Guinea-Bissau appears to be among the lowest in the world. Still, in comparison with neighboring countries, the figures on educational performance are not extreme, as Table 2.2 shows. However, there are indications that the enrolment rate in primary education has decreased since the mid-1980s[11]. The lack of teachers, their low qualifications, and the absence of a clear policy regarding the teaching language are mentioned as the most serious problems affecting the performance of the educational system.

The lack of teachers and their low qualifications can be attributed to the attempts to reduce government expenditures, and to a change of development priorities in the mid-1980s. The fiscal expenditures going to education decreased from PG 1,152 million in 1986 to PG 782 million in 1988[12]. Only one percent of public investment in education was financed by the government. As the economy was liberalized and inflation picked up, teacher's salaries were not raised accordingly. Subsequently, the most qualified teachers left their profession, and the best students chose other activities after graduation. Moreover, the incentives for completing school became weaker when petty trading and small scale business became more attractive than positions requiring more formal schooling.

10 WB (1990), p. 4.
11 WB (1990).
12 WB (1990), p. 4.

The language dispute steams from the fact that Creole is the most frequently spoken language, but Portuguese which is often the third language of school children and teachers, is the official language. The choice of Portuguese as the medium of communication, and the emphasis given to classical subjects at the expense of vocational training, are signs that the formal education system ignores traditional knowledge and does not provide practically useful skills. These factors, combined with shrinking fiscal resources and poor management of the educational system, have led to deteriorating standards and a weak performance.

Despite substantial donor support to efforts to extend health and education to broader groups of the population, actual performance shows that very little has been achieved in the field of human capital development. Moreover, there are indications that resources remain unequally distributed, with a high concentration to Bissau and more resources going to males than to females.

The lack of comprehensive information on the household sector makes it difficult to discuss questions related to poverty, income distribution, and gender issues. However, a household survey is currently prepared, with the main objective to provide a more accurate basis for the calculation of price indices. This, together with a recently completed population census, will improve the availability of information and facilitate the analysis of questions related to the social sector.

TABLE 2.1. Health indicators for some West African countries.

	Guinea Bissau	Senegal	Guinea	Sierra Leone
Life expectancy at birth (1987)	39	48	42	41
Infant mortality per 1,000 live births (1965)	196	171	196	209
Infant mortality per 1,000 live births (1987)	148	131	149	154
Population per nurse (1965)	..	2,640	4,750	4,470
Population per nurse (1984)	1,130	2,090	6,380	1,090

Source: WB (1989), Tables 1, 31 and 33.

TABLE 2.2. Educational indicators for some West African countries (percent).

	Guinea Bissau	Senegal	Guinea	Sierra Leone
Male literacy rate (1990)	24	25	13	11
Female literacy rate (1990)	36	38	24	21
Primary school enrolment (1970)	39	41	33	34
Primary school enrolment (1990)	59	58	37	48
Secondary school enrolment (1990)	7	16	10	16

Source: WB (1993).

CHAPTER III

ECONOMIC POLICIES SINCE INDEPENDENCE

3.1. Historical Perspective

As in many other African countries, the colonial era did not establish any firm foundation for a strong private sector in Guinea-Bissau. The economic institutions exported by Portugal to Portuguese Guinea aimed to guarantee monopolies for a few Portuguese firms and left a subordinate role to Guinean participation. The structure of the Portuguese colonial empire was based on centralized economic decisions and a minimum of foreign competition. Compulsory harvesting of groundnuts and forced deliveries of export crops were the rules imposed by the colonial power. Government trading centers were set up in order to capture as much of the peasant production as possible[13].

13 Galli and Jones (1987), p. 33.

The colonial institutions endowed Portuguese Guinea with a strong public sector and relatively large, oligopolistic firms that drew their capital from Europe. The later decades of the colonial period witnessed an enormous expansion in the power and impact of the formal, regulated economy in Portuguese Guinea. The forced labor system and the controlled prices imposed by the Portuguese led to extensive emigration of Guinean farmers to neighboring countries and to smuggling of goods across the borders. However, the colonial government was unable to control domestic informal trading, migration patterns, and indigenously controlled long-distance trade due to lack of resources and technical capabilities. Some 70 percent of economic transactions were based on barter and most rural Guineans engaged in economic activities that were neither controlled, taxed, nor monitored by the government[14].

When looking at the present disequilibria in the macroeconomic development of Guinea-Bissau, it is worth to remember that structural imbalances did not begin with the command economy that was established after Independence. During the 1940s, imports began growing rapidly, while export volumes stagnated. The increases in imports reflected the expanding demand of the colonial administration. There was an overall deficit in external trade between 1941 and 1950, and the last year in which the trade balance was positive was 1956. Table 3.1 illustrates the imbalances between imports and exports since the 1950s. The deficits were financed by large capital transfers from Lisbon, and Portuguese Guinea accumulated an external debt that in the 1950s amounted to 15 percent of export earnings. The imbalances also showed in the fiscal budget: in 1970, almost a third of the colonial budget was made up of "development investments" financed directly from Lisbon, mostly as long-term credits[15]. According to Galli and Jones (1987, p. 52) the imbalances during the colonial period "set a precedent for Guinea's future leaders that proved difficult to resist, i.e. dependence on external borrowing in order to maintain a certain standard of living for the privileged stratum".

14 Forrest (1992), pp. 27-28.
15 Engellau (1974, p. 33. Also Rylander (1979), p. 18 and 23, and Galli and Jones (1987), p. 52.

TABLE 3.1. The trade deficit and the rate of coverage of imports by exports (1,000,000 Escudos until 1974, million USD at current prices from 1980).

	Imports	Exports	Trade deficit	Rate of coverage (%)
1951	188.1	168.3	19.8	89
1955	221.1	178.2	42.9	81
1960	321.7	198.6	123.1	62
1965	419.3	123.7	295.7	29
1970	786.0	106.4	679.6	14
1974	1,095.3	88.4	1,007.0	8
1980	61.1	11.3	49.8	18
1986	51.2	9.7	41.5	19
1990	68.1	19.3	48.9	28

Sources:

1951-1955:	Rudebeck (1974), Table 3, p. 17.
1960:	Provincia da Guiné (1972), p. 85.
1965-1974:	Galli and Jones (1987), Table 3.4, p. 51.
1980:	WB (1987), Table 3c, p. xii.
1985-1990:	Balance of Payments, Banco Central da Guiné-Bissau.

3.2. Economic Policies until 1983

After Independence, the new government gave priority to the diversification of the economy through import substitution of consumer goods and processing of primary products for export. A major part of foreign grants and loans were used to finance technology imports to build a state-owned industrial sector, despite the strong agricultural bias of the economy. With foreign financial and technical support, the government invested large resources in industrial projects that were inappropriately large and unsuitable for Guinean conditions. The plants operated at very low levels of capacity utilization and returns were insufficient to repay the foreign loans. Arrears on interest payments and amortizations accumulated and led to increasing foreign indebtedness. At the same time, the imports of investment goods crowded out imports of consumer goods, which caused growing shortages in urban and rural markets.

This development strategy was pursued within the framework of a socialist economy. The state directed the economy and played a central role in domestic and international trade. Import licenses were granted to importers on the basis of their past import shares, a system that favored the large state trade companies. Export licenses were granted automatically, but the state had a monopoly on the exports of groundnuts, palm kernels, sawn wood and logs, shrimps, fish, beer, soft drinks, groundnut oil, and parquet flooring, i.e., practically all of the country´s exportable products. Most exports were subject to export duties.

The development strategy had a marked urban bias. Farmers were considered to be insensitive to prices and were largely seen as providers of exports and cheap food products for the urban population. A distribution network for collection of rural produce and sales of consumer goods was established through two companies, the Armazens do Povo (People's store) and SOCOMIN, the former Portuguese trading company Sociedade Comercial Ultramarina, that was nationalized in 1977. Most prices were fixed by state authorities. In 1977, the system was modified, but basic food products were still subject to price controls. The administratively fixed prices were low, discouraging production for the market, and since they were often fixed below import costs, they led to losses for the trading companies. Retail prices were also controlled and did not take into account domestic transportation costs, which contributed to the severe shortages of consumer goods in the countryside. Peasant production was also discouraged by the low output prices and the lack of incentive goods, and the farmers responded by withdrawing from the formal

markets, diverting their surplus production to informal markets and to smuggling. Lack of agricultural goods in the official market, in turn, contributed to lower capacity utilization in the industrial plants processing agricultural products.

In 1976, the National Bank of Guinea-Bissau implemented a currency reform. A new monetary unit, the Guinean Peso (PG) was created, with a value fixed at par with the Portuguese Escudo and an exchange rate vis-a-vis the SDR of PG 33.93 (USD 1 = PG 25.55)[16]. The PG fluctuated with the Escudo until 1978, when it was pegged to the SDR at the rate of PG 44. The exchange rate between the PG and the USD did not change substantially until 1983 (see Table 3.2). Exchange controls were levied on all capital receipts and payments. Foreign exchange proceeds had to be surrendered to the National Bank of Guinea-Bissau and residents were forced to declare their exchange holdings abroad to the National Bank.

The administrative price controls, together with the state monopolies on internal and external trade, constituted an implicit tax on the rural sector. The urban bias was upheld in order to keep down urban food prices, which allowed the government to keep public salaries low. Except for the emergence of parallel markets and widespread smuggling to neighboring countries, this also created inflationary pressures: official prices were kept low in spite of the large gap between demand and supply, and consumers were forced to turn to parallel markets with much higher prices.

In 1977, the system of import licenses was suspended and only imports considered urgent or essential were permitted. At the beginning of the 1980s, domestic trade had stagnated and there was a severe shortage of foreign exchange that led to further suppressions of imports.

Central planning also led to an expansion of the public sector, and the state apparatus grew large and bureaucratic. Public expenditures expanded as a result of ambitious investment plans, rapid expansions of the education and health sectors, and the financing of loss making state enterprises and bureaucrats. Revenues fell sharply as formal sector activities were substituted by thriving parallel markets. The fiscal budget showed large deficits that were mainly financed by credits from the Central Bank, fuelling inflation. In short, the country was characterized by large macroeconomic imbalances.

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16 WB (1982), Vol. I, p.27.

The industrial investments had been financed by grants and loans from bilateral and multilateral development agencies. Given the weak profitability of the industrial sector, it was obvious that scheduled interest payment obligations could not be met. External debt mounted and arrears accumulated. The balance of payments deteriorated and the country became extremely dependent on aid. The situation became critical, and discussions about systemic reform commenced after political changes in 1980: the ruling president Luiz Cabral was ousted in a military coup that brought the present leader, João Bernardo Vieira, to power. However, the first reforms did not materialize until 1983.

3.3. The Economic Recovery Program, 1983 - 1985

At the end of 1983, the government launched an Economic Recovery Program (ERP) intended to revitalize the economy. The program was supported by the first tranche of a stand-by loan from the International Monetary Fund (IMF) and by two Reconstruction Import Credits from the International Development Agency (IDA, World Bank). The primary objectives of the program were to attend to the large imbalances in the economy, to restructure the inefficient public sector, and to stimulate production.

The ERP aimed to cut the external deficit by lowering demand, mainly by reducing the chronic fiscal deficits. The policies included both constraints on public expenditures and tax increases. On the supply side, the recovery program intended to correct the large price distortions through devaluations (which were also expected to lower the level of demand) and through liberalizations of domestic trade.

The currency was devalued from PG 40 to PG 82 per USD at the outset of the ERP, and it was announced that the exchange rate would henceforth be subject to monthly adjustments. Producer prices, consumer prices, and taxes were increased. During 1984, the recovery program proceeded with austere financial and monetary policies and the introduction of a new system for the allocation of imports. Imported products were distributed to retail traders in proportion to the agricultural export products collected and delivered by them to the state marketing system during the preceding crop year. The export duties were abolished and replaced by a more limited list of export taxes.

In 1985, however, the strict economic policies were relaxed, which led to a deterioration of the economic conditions and, eventually, to an end of the whole recovery program. Public expenditures were financed with credits from the National Bank, which caused

inflation, and the prices established by the government failed to produce the shift in relative prices in favor of export products. The incentives for selling through the official channels were not sufficient, and parallel markets and smuggling continued to undermine the official economy. Low exports and high import content in the large public investments made it difficult to improve the balance of payments. This resulted in further cuts in the imports of consumer goods, worsening the already serious shortages. Sharp decreases in the world market prices of major export crops and delays in the disbursements of international assistance contributed to the difficulties.

The deteriorating situation during the period 1982-1985 is reflected in several of the macroeconomic indicators. The annual average growth rate of GDP was only 1 percent. Private consumption grew by 4.8 percent and public consumption by 3.9 percent per year between 1982 and 1986. The current account deficit more than doubled, from 23 million USD in 1981 to 49.76 million USD in 1985. The stock of external debt quadrupled, to a total of 280 million USD in 1985. The debt service ratio increased from 28 percent of export earnings in 1981 to 56 percent in 1986. Government finances deteriorated correspondingly, as the budget deficit increased from 28 percent of GDP in 1981 to 48 percent in 1985[17].

3.4. The Structural Adjustment Program of 1986

After the failure of the ERP, the Guinean economy was characterized by high inflation, extensive parallel markets for goods and foreign exchange, smuggling, stagnating official trade and large deficits in the government budget. The external situation was not much less dramatic. Gross foreign reserves corresponded to two weeks of imports and the debt service ratio has increased to 56 percent of annual export earnings, as noted above. Severe shortages prevailed in rural markets. Despite the fact that the government had raised the purchase prices for agricultural crops in 1986, and in spite of plentiful rainfall and a good harvest, a large part of the population suffered from a shortage of food staples. Forrest (1992) reports that in the non-rice-producing regions, such as Bafatá and Gabu, rice was considered virtually a luxury and the shortages caused malnutrition[18].

17 WB (1987), pp. 3-8.
18 Forrest (1992, p. 109.

A Structural Adjustment Program (SAP) was prepared in 1986, with the assistance of the IMF and the World Bank[19]. The program set out to stabilize the economy by introducing prudent fiscal, monetary, and exchange rate policies, complemented by price and trade liberalization measures. The improvement of public sector management was another important objective.

Like the previous recovery program, the SAP aimed to improve domestic relative prices of tradables through devaluations of the currency and price liberalizations, in order to stimulate domestic production. However, the need for fiscal and monetary discipline was stressed harder than before, in order to avoid inflationary pressures that could erode the impact of the devaluations on relative prices.

More specifically, the authorities started to liberalize prices in August 1986. At the same time, the tight state control on internal and external trade was abolished. The private sector was permitted to export both traditional and non-traditional products and quantitative import restrictions were removed for all goods, except cereals, petroleum products and pesticides, where trade remained under the control of state monopolies. One of the few remaining quantitative regulations stipulated that 50 percent of foreign exchange earnings from exports were to be exchanged to local currency at official rates.

By the beginning of 1989, most prices had been liberalized, except for those for sugar, cooking oil, fertilizers, and petroleum products imported by the public sector. The export tax on cashew nuts had gradually been reduced from 80 to 45 percent, all other export taxes had been abolished and only the import monopolies for cereals and petroleum products remained with the state. One of the two dominating trade parastatals had been liquidated and privatization of the other was discussed. International trading firms were allowed to deal directly with domestic private firms and these firms were permitted to trade directly with farmers. In the domestic markets, private merchants were allowed to set up retail shops independently of the public distribution network.

The results of the reforms were unclear during the first years after their implementation. According to Hugo, Zach and Ribeiro (1989), the number of market actors increased as several hundreds of small mobile traders came into business, leading to increased competition at the farm level, higher prices, and greater bargaining power for the farmers.

19 The government prepared a Policy Framework Paper in April 1987, with assistance of the IMF and the World Bank. The first of two annual Structural Adjustment Facilities was approved by the IMF in October 1987. The IDA/World Bank also supported the program with a first Structural Adjustment Credit (SAC I).

Vilela and Lencart (1989) claim that the public companies continued to exercise oligopolistic power and that the private traders generally visited local markets only once a year. However, with hindsight, it is clear that the number of market participants has increased and the market power of the individual traders has been reduced. At the same time, wholesale trade remains concentrated to a few agents simply because of the small size of the national market. There appears to be some degree of collusion among these wholesale traders, as a result of what there have occasionally been sudden increases in the price of rice.

As noted above, the SAP also included sharp devaluations in order to reduce the overvaluation of the Peso. In May 1987 the currency was devalued by 60 percent, from PG 263 per USD to PG 650 per USD[20]. This sizable devaluation contributed to narrow the gap between the official and parallel rates. Thereafter, the government followed a policy of weekly devaluations, a crawling peg. The evolution of the nominal exchange rate between the PG and the USD is presented in Table 3.2.

TABLE 3.2. Nominal exchange rate between the PG and the USD (December 31, buying official rates)

1977	33.6	1985	174.7
1978	33.7	1986	232.0
1979	n.a.	1987	767.8
1980	34.2	1988	1,363.1
1981	37.1	1989	1,986.0
1982	39.2	1990	2,508.6
1983	82.5	1991	5,118.9
1984	127.2	1992	9,088.3

Source: Exchange Arrangements and Exchange Restrictions, Annual Reports, 1977-1993, International Monetary Fund.

20 The Guinean Peso (PG) was pegged to the SDR (Special Drawing Right) in May 1978. In January 1991 the PG was pegged to the Portuguese Escudo in the context of a monetary arrangement with Portugal, but in December 1992 the USD replaced the Escudo as the peg currency. The intervention currency has been the USD during the whole period.

3.5. The Second Phase of the SAP, 1989-1993

The economic results of the first phase of the SAP were ambiguous. On the one hand, the government succeeded in deregulating the economy, abolishing public monopolies and liberalizing the price system. During the period 1987-1989 the growth rate of GDP was between 4 and 6 percent. The exports of goods increased by 58 percent between 1986 and 1987, and stabilized at a level of about USD 15 millions. On the other hand, the program was undermined by high inflation, because the authorities failed to stick to strict fiscal and monetary policies, in spite of the requirements for discipline outlined in the program.

In 1989, the government launched a second phase of the Structural Adjustment Program[21]. A second Structural Adjustment Credit (SAC II) from the World Bank was negotiated in May 1989, and subsequent disbursements were conditioned on specific policy measures to be undertaken by the government. Among them were public sector reform, privatization of public enterprises, fiscal and custom reforms, rationalization of the Public Investment Program (PIP), reduction of the export tax on cashew nuts, and an active exchange rate policy aiming to keep the gap between the official and the parallel exchange rates below 20 percent.

The performance during the second phase of the SAP has also been mixed. Table 3.3 presents some economic indicators to illustrate this development.

At the beginning of 1989, the remaining price controls on sugar, cooking oil, and fertilizers imported by the public sector were removed, the state monopoly on cereals was abolished, and the export tax on cashew nuts was reduced to 34 percent[22]. Trade procedures were simplified, automatic issuing of import and export licenses was introduced, and the different exchange rates for various trade operations were unified.

21 The Policy Framework Paper for the second phase of the SAP was updated in April 1989, with assistance of the IMF and the World Bank. Due to program slippages, the IMF postponed the negotiations for a third Structural Adjustment Facility. IDA/World Bank supported the second phase of the program with a second Structural Adjustment Credit (SAC II), the first tranche of which was released in June 1989. Disbursement of the second tranche was delayed due to poor program performance during the second half of 1989. After an improvement in performance during the second half of 1990, the second tranche was released in January 1991. Credit expansion above targets and program slippage also caused a delay in the disbursement of the third tranche, which was not released until June 1993.

22 In 1991, the state monopoly on imports of petroleum and petroleum products was abolished, and the export tax on cashew nuts was further reduced to 25 percent. Price controls on petroleum products remained in force, but the products were sold at import parity levels.

TABLE 3.3. Economic Indicators 1987-1992

	1987	1988	1989	1990	1991	1992
Increase means of payments (%)		73.3	38.6	68.9	36.3	111.0
Increase credit to the government (excl. counterpart funds) (%)		24.7	163.4	81.4	-1.3	44.2
Increase credit to the private sector and public enterprises (%)		107.4	96.2	24.1	16.0	10.5
Inflation (Annual Average) (%)	81.8	67.5	80.8	34.4	55.7	70.0**
Inflation (Dec. to Dec.) (%)	96.9	50.3	68.3	31.0	62.0	88.0**
Devaluation PG/USD (Dec. to Dec., official buying rate) (%)	256.7	60.1	45.8	26.2	97.7	74.5
Parallel Market Premium PG/USD (%)	52.9	24.9	36.0	13.7	13.3	5.0
GDP Growth (%)	5.6	6.9	4.5	3.3	3.0	2.8*
Gross National Savings / GDP	-2.07	-12.8	-14.8	-1.3	-9.3	-22.1
Current Account (excl. Official Transfers) / GDP	-35.4	-47.0	-49.1	-25.9	-36.3	-48.6
Current Account (incl. Official Transfers) / GDP	-7.8	-18.6	-19.7	-7.0	-19.2	-32.4

Note: * projected
** IMF (1993)

Source: BCGB, different publications.

Important institutional changes in the banking sector took place during this period. The old Banco Nacional da Guiné-Bissau (BNGB) was restructured and it abandoned commercial operations to form the Banco Central da Guiné-Bissau (BCGB), which has been in charge of monetary policy since March 1990. The Banco de Crédito Nacional (BCN) was created to liquidate the credit portfolio of the old BNGB, but during its first months of operations it created new net credit, which subsequently led to its closure. The first private bank, Banco Internacional da Guiné-Bissau (BIGB) started its operations in March 1990. In 1993, the financial system comprised two private banks with several branch offices across the country. The financial system is still very weak and has difficulties in meeting the requirements of the private sector, which, in turn, lacks confidence in the banking system.

Monetary policy has shown a weak performance during the period since 1989. There have been several incidents of credit expansion, for instance through the development credit unit (DESECO) of the Banco Nacional in 1989, and the Banco de Crédito created to liquidate DESECO in later years. However, since 1992, the authorities have tried to control the increase in domestic credit, adjust interest rates, collect outstanding debts, make lending procedures more transparent and controllable, and put ceilings on the financing of the fiscal deficit by the Central Bank.

High domestic inflation forced the monetary authorities to pursue a crawling peg with frequent adjustments of the nominal exchange rate, in order to avoid a deterioration of external competitiveness. This area of policy was successful and for most of the period the disparity between the official and the parallel exchange rates did not exceed 20 percent. More recently, the gap has been reduced to less than 5 percent.

Public sector reforms have concentrated on the privatization of public enterprises and the establishment of control, information and management systems in several institutions, such as the Central Bank, the Ministry of Finance, the Planning Secretariat, and other ministries.

By 1992, six major public enterprises had been privatized and privatization of another three was discussed. The electrical company, EAGB, was financially reorganized, and its management was taken over by a French company. The state oil company, DICOL, had accumulated a large debt to the Treasury, and measures were undertaken to recover the debt and to speed up the transfer of gasoline tax revenues from DICOL to the state budget. Tax and tariff reforms were carried out and the management and control functions of the custom administration were revised. These changes are potentially important because taxes on international trade make up a large part of government revenues, but the effects on the budget have not materialized yet.

The reforms also aimed to improve the efficiency of the Public Investment Program (PIP). The PIP is the institutional framework for public investment, which is reported separately in the government budget. It includes a large number of projects financed by donor funds and accounts for a major share of the total aid received by Guinea-Bissau. However, the PIP has been more a list of projects reflecting donor preferences than an expression of the conscious development objectives of the national government. This is because there has been a lack of local capacity to generate and evaluate projects and to define development priorities. Moreover, the PIP includes several projects that have little to do with fixed capital formation but are instead made up of current expenditures. The SAP strived to reduce the size of the PIP and to increase the share of projects focusing on fixed capital formation, particularly in infrastructure. The reforms have been partly successful: the number of projects has been reduced, but the domestic capability to assess and implement projects is still lagging behind.

In addition to the policies focusing on the PIP, there have been other measures to reduce public expenditures and to increase revenues. On the expenditure side, several programs have attempted to reduce public employment. It has proved difficult to increase public revenues, mainly because it has been difficult to expand the tax base. The government has not been able to benefit from the economic expansion, since a large share of the activities are still undertaken outside the formal sector.

As noted earlier, the administrative reforms have not yet had very much impact on the fiscal budget. As a result, the government budget still shows large overall deficits. Private savings have never been sufficient to balance the government's negative savings (in fact, private savings have often been negative) which means that foreign funds have covered the gaps, and the current account of the balance of payments has registered large deficits.

At the beginning of 1993, the government reached an agreement with the IMF on targets for fiscal and monetary policies, including detailed specifications on budgetary revenues and expenditures, expansion of the money supply and a maximum acceptable spread (5 percent) between the official and the parallel foreign exchange rates. These targets were supported also by the World Bank. The government's commitment to these targets, and progress made on various parts of the SAP, persuaded the World Bank to release the third tranche of the SAC II in June 1993, despite the weaker results in areas of fiscal and monetary policies. The impact of this decision is significant, since the release of other donor funds were conditional on the release of World Bank funds.

3.6. Conclusions

Exchange rate flexibility, trade and price liberalization, and reduction of export taxes have been the most successful areas of the SAP. However, the impact of these actions on the quantities of exports and imports has been small and Guinea-Bissau still shows a large current account deficit that is financed by inflows of grants and concessionary capital. The country also faces difficulties to pay interests and amortizations of external debt.

The impact of the reforms on the current account deficit have been small, which indicates that there are problems relating to the design and the implementation of the adjustment program. Firstly, the prices of agricultural products have not increased as much as those in commerce and construction, which means that the incentives to promote substantial private investments in the agricultural sector have been low. The sectoral deflators in the national accounts confirm this tendency. Secondly, changing the structure of the economy means moving labor, land and capital from one use to another. However, factor markets are not likely to be very flexible when infrastructure is inadequate, and technological capabilities, skilled labor, and domestic credit are in short supply. Both export diversification and domestic production of import substitutes will occur slowly because of these constraints, even if policies provide the correct price incentives.

Nevertheless, there is some anecdotal evidence suggesting that there have been increases in exports that are not registered in the balance of payments, such as exports of timber and fish, and reexports of imported rice to neighboring countries. These exports generate foreign exchange income used to finance imports. Since imports are registered in the balance of payments, but these exports are not, the country´s accounts may not give an accurate picture of the extent of the resource mobilization that the reforms have generated. Moreover, inofficial (and illegal) exports which are not registered in the firms´ operations are not subject to taxation, and reduce the tax base.

The excess supply of liquidity in the economy in the form of credits to the private and public sectors has generated inflationary pressures and led to a high level of domestic expenditures, which is reflected in negative gross national savings. The exchange rate policies have been accommodatory, aiming to avoid losses in competitiveness in the presence of high domestic inflation. At the same time, it is possible that the exchange rate flexibility has reduced the country´s willingness to follow restrictive domestic monetary policies.

The long term effects of the policy changes are difficult to assess. On the one hand, the Guinean authorities have shown a commitment for the transition to a market economy and carried out price, trade, and exchange liberalization. They have also directed very scarce resources to areas that play a key role in economic reform, like central banking and public sector finances. On the other hand, most of the institutions have to be created from scratch, and although an improvement seems to be on its way, substantial results are still not clearly visible. The private sector has reacted to the changing environment, but since it suffers from several constraints that increase risks, it has focused on activities with quick returns. Lack of monetary discipline and high inflation have also led to volatile relative prices and encouraged private agents to focus on activities that are profitable in the short run, but which have an uncertain impact on economic growth.

CHAPTER IV

THE MACROECONOMIC EFFECTS OF AID

The previous chapter described the macroeconomic reforms implemented in Guinea-Bissau during the past decade, and implied that multilateral development agencies, e.g. the World Bank and the IMF, played an important role in identifying development priorities and designing the various policy packages. In this chapter, we focus more closely on the role of foreign aid, and examine the macroeconomic effects of the inflows of foreign aid money to Guinea-Bissau. Our empirical analysis is based on a methodology presented by White (1994). This approach departs from an "accounting framework" that identifies the relationships between aid and different macroeconomic variables appearing in the recipient country's national accounts, e.g. the government budget and the balance of payments (BoP). The fundamental relationships between variables can be summarized in the equation:

(1) Savings Gap = Capital Account Balance = Current Account Balance.

This identity states that the savings gap, which is the difference between gross national savings and investment, must by definition be equal to the capital account balance, i.e. the net flow of foreign savings, and that the value of this flow must equal the current account balance. For instance, a country where domestic investment exceeds savings must have a net inflow of foreign resources that covers the difference. This inflow will be registered as an inflow of capital in the country's capital account and as a deficit in the current account of the balance of payments. An inflow of foreign aid in the form of a concessional loan to be used for import of investment goods, which is recorded in the capital account, will also be reflected in the current account as increase in imports, and in the savings gap as increase in investments, since the identities in equation (1) must always hold.

Aid consists of grants and concessional loans that are reported in the current and capital accounts. These accounts also include variables reflecting imports and exports of goods and services, factor payments, changes in reserves, and other capital flows. Similarly, the savings gap can be disaggregated to show private and public savings and investment, as well as government revenues and expenditures. Hence, by breaking down the variables appearing in equation (1) into their separate components, it is possible to explicitly analyze the relationships between inflows of aid and changes in various macroeconomic aggregates, such as imports, exports, savings, investment, and government finances.

Below, we first discuss the data and variables that are available to construct our accounting identities for Guinea-Bissau. We continue by examining the relationships between the variables in the two accounts that make up the country's external balance, i.e. the current and capital accounts. The last part of the chapter extends the analysis to the country's internal balance, which is reflected in the savings gap.

4.1. Data Sources and Data Availability

Implementing the accounting framework discussed above requires a comprehensive and consistent data base. The consistency requirement means that data and variables included in the savings gap (the internal balance) from the national accounts must be compatible with data on current and capital accounts (the external balance) from the balance of payments.

There are several possible data sources that can be used to construct series for the accounting identities. We have chosen to base our empirical analysis on information provided by the national authorities of Guinea-Bissau. However, Guinea-Bissau does not publish official national accounts of the kind available in other countries, although various government departments publish semi-official reports and statistics in their specific areas. The structure of these reports is not standardized, which means that it is difficult to construct long series for some variables. For most of the variables needed to construct our accounting identities, the national sources provide consistent data from 1986. Consistent data on the government budget are available only after 1987. Hence, it is obvious that the scope of empirical analysis is limited by the lack of longer time series.

The data presented in the national accounts are scrutinized by the World Bank and the IMF and they are supposedly the primary source of information for the various reports published by these organizations. We have translated all data to current USD, using yearly average exchange rates, as published by the Central Bank of Guinea-Bissau. The reason is the difficulty to construct a data series in constant PG, because the coverage of the only available price index is limited to food, beverages and tobacco.

The alternative data sources all suffer from more or less serious weaknesses. For instance, it is possible to construct some of the accounting identities using data from the World Tables published by the World Bank. However, these data are only available at high levels of aggregation and they often differ from those given by national sources (that have supposedly been scrutinized by the World Bank itself). Similarly, it is possible to find some statistical information in various reports by national and international organizations, but these sources are incomplete because they cover only few variables and limited time periods and because they are not consistent with the national accounts when comparisons are possible. Moreover, several of the reports do not report the origins of their information or how their statistics have been calculated.

Regarding information on aid inflows to Guinea-Bissau, there are also several alternative data sources. Firstly, there are national data from the Guinean balance of payments, based on information collected by the Ministry of Foreign Affairs and International Cooperation. These are the data we use in the subsequent analysis. There are also two sources of data based on donor reports: these are the publications of OECD's Development Assistance

Committee (DAC) and World Debt Tables, from the World Bank. The figures reported in these three sources often differ significantly, and it is useful to discuss the accuracy of the aid data before examining the accounting identities.

The term 'aid' in the accounting framework consists of two separate elements: grants and net disbursements of concessional loans. Grants can be recorded with or without technical assistance (TA). Technical assistance grants often consist of resources spent on experts and consultants from donor countries. The TA funds may not always be fully recorded in the recipient countries, since some payments may be made directly by donor agencies to expatriate experts. Hence, TA may partly explain some of the discrepancy between grant data from different sources. Net disbursements of concessional loans, or net resource flows as they are also called, consist of two elements: loan disbursements minus amortizations on existing debt. Here, discrepancies between the sources may be related to differences in how amortizations are recorded.

Information from all three data sources simultaneously is only available for the period 1987-1990, as presented in Table 4.1. DAC and World Debt Tables report data also for earlier years, but appropriate BoP data are not available before 1987. The last year reported in World Debt Tables is 1990.

Data for total aid inflows during the period 1987-1990 from DAC 1991 (OECD, 1991) and World Debt Tables are similar. The aggregate inflows (grants plus net disbursements of concessional loans) 1987-1990 amounted to USD 430 million, including TA grants. However, the concordance in the total amounts appears to be a coincidence, since the figures for each year differ. DAC data have been revised in the 1992 report (OECD, 1992), and the revised data are not consistent with the available data from World Debt Tables.

Comparing data from national sources and donors, it should be noted that the Guinean BoP does not provide information about net disbursements of concessional loans. We have therefore calculated the net disbursements of concessional loans by complementing the BoP data with data on the repayments of principal from statistics on external debt provided by the Ministry of Finance. The net disbursements of concessional loans plus grants for the entire period, calculated this way, amount to USD 313.5 million. Hence, the net inflows of aid reported in BoP during the period 1987-1990 are about 27 per cent lower than those reported by the donors. Technical assistance paid by donor countries but not registered by the recipient may explain this difference. However, a difference of 20 per cent still remains when technical assistance grants are deducted from both sources.

TABLE 4.1. Official development assistance to Guinea-Bissau, as reported by different sources, 1987-90 (In million USD)

	DAC Grants & Loans (Net)	WDT (Grants excl. TA)	WDT (TA)	WDT (Loans, Net Disburs.)	WDT Total (Net)	BoP (Grants excl. TA)	BoP (TA)	BoP (Loans, Gross Disburs.)	BoP Total (Gross)	BoP Total (Net)
1987	111	42.4	27.3	39.1	108.8	34.3	11.3	33.1	78.7	75.0
1988	99	37.7	33.4	33.4	104.5	32.7	11.3	33.4	77.4	76.0
1989	102	51.0	25.2	35.6	111.8	46.9	11.3	37.0	95.2	90.4
1990	118	59.8	12.1	33.1	105.0	34.0	10.1	30.9	75.1	72.3
Total	430	190.9	98.0	141.2	430.1	147.9	44.0	134.4	326.4	313.7

Sources:
DAC: OECD (1991)
WDT: World Debt Tables, WB (1991)
BoP: Balance of Payments, Banco Central da Guiné-Bissau

Some further information is provided by a survey conducted among donors by the United Nations Development Programme (UNDP), in order to estimate the actual aid flows during one single year, 1990. According to their results, total aid to Guinea-Bissau amounted to USD 97 million. This total should be compared with USD 139 million reported in DAC 1992, USD 118 million reported in DAC 1991, USD 105 million reported in World Debt Tables and USD 75 million reported by national authorities. Thus, the UNDP survey suggest that donor information overestimates aid by between 8 and 43 percent, while the national sources only report 80 percent of the amounts received.

Summing up these findings, the figures on flows to Guinea-Bissau differ significantly between the alternative data sources. It appears that the Guinean balance of payments understates the inflows, but perhaps not by as much as implied by a simple comparison with donor sources. We use the national sources in the ensuing analysis, primarily because they are consistent with other information in the national accounts.

4.2. Definition of Variables: The External Balance

The first of the accounting identities we will examine equates the current and capital accounts in the balance of payments. Disaggregating, we can express the identity as:

(2) X + NTR + NFP - M = -(LTLc + LTLn + STL + OKI + dR)

where

- X is exports of goods and non-factor services;
- NTR is net current transfers, which includes official transfers, OT (which is grants) and private current transfers, PCT;
- NFP is net factor payments from abroad;
- M is imports of goods and non-factor services;
- LTLc is net disbursements of concessional long-term capital;
- LTLn is net disbursements of non-concessional long-term capital;
- STL is net short-term inflows;
- OKI is net other capital inflows; and
- dR is the change in reserves (a positive dR is a reduction in reserves, i.e. an inflow of capital to the capital account).

Data on the current and capital accounts of Guinea-Bissau are presented in Table 4.2. The data are taken from the BoP published by the Central Bank of Guinea-Bissau, and the variables correspond to those appearing in equation (2), with three exceptions. There is no item called LTLn, because there are no such inflows, the entry "Errors and Omissions and Short Term Cap" in the BoP is equivalent to STL plus OKI in the equation, and LTLc are presented as gross (instead of net) disbursements. There are data on scheduled amortizations, arrears, and debt rescheduling, but it is not possible to construct reliable series on net disbursements of concessional long-term capital from the balance of payments, because the information on arrears does not distinguish between interests and principal. However, there is information about amortizations from 1987 and onwards, provided by the unit working on external debt at the Ministry of Finance. This information is not included in the balance of payments, but we have added it to Table 4.2, and used the information to construct a series of "net" aid. In the BoP, data on the service balance are presented separately from the exports and imports of goods. The series of exports and imports of goods and non-factor services are presented later, in Table 4.6.

To include aid into this framework, we note that aid consists of official transfers, i.e. grants and long-term concessional loans. In other words:

(3) AID = OT + LTLc

Combining equations (2) and (3) and rearranging the terms, we can begin to examine the macroeconomic effects on the basis of the identity:

(4) AID = M - PCT - NFP - X - LTLn - STL - OKI - dR,

which in the case of Guinea-Bissau takes the form:

(4') AID = M - PCT - NFP - X - EO & STL - dR.

TABLE 4.2. Balance of Payments 1986-1992 (In million USD)

	1986	1987	1988	1989	1990	1991	1992
Trade Balance	-41.50	-29.30	-43.00	-54.70	-48.81	-47.03	-77.00
Exports fob	9.70	15.40	15.90	14.20	19.26	20.44	6.50
Imports fob	-51.20	-44.70	-58.90	-68.90	-68.07	-67.47	-83.50
Services excl. NFP	-24.40	-24.90	-27.00	-36.70	-24.81	-30.22	-30.34
Trade Balance (goods and services)	-65.90	-54.20	-70.00	-91.40	-73.62	-77.25	-107.34
PCT: Private transfers	-1.50	-2.00	1.50	1.20	1.00	-4.14	-0.64
NFP: Net Factor Payments	0.90	-2.30	-4.40	-6.60	12.22	3.55	0.25
Current Account excl. OT	-66.50	-58.50	-72.90	-96.80	-60.40	-84.94	-107.77
OT: Official Transfers	43.50	45.60	44.00	58.20	44.16	39.96	35.69
Current Account incl. OT	-23.00	-12.90	-28.90	-38.60	-16.24	-44.97	-72.08
Capital Account:							
A. Official Medium & Long Term Disburs.	17.90	33.10	33.40	37.00	30.92	36.70	44.50
BOP Support	2.60	16.80	20.70	15.70	11.34	14.23	0.00
Projects	15.30	16.30	12.70	21.30	19.58	22.47	35.50
B. Scheduled Amortization	-8.10	-14.50	-15.20	-27.70	-18.36	-31.22	-33.29
C. Errors and Om. & Short Term Cap.	-3.70	-3.70	4.10	-9.70	-4.16	-13.36	33.91
Refinancing of Arrears:	4.10	-36.90	7.10	11.00	6.68	30.70	33.49
D. Increase	4.10	-36.90	7.10	11.00	9.22	37.10	40.02
E. Decrease					-2.55	-6.39	-6.53
F. Variation in Reserves	4.20	-11.00	-12.30	7.70	-14.67	9.57	-6.32

Source: Central Bank of Guinea-Bissau and unit of external debt at the Ministry of Finance

TABLE 4.2. Balance of Payments 1986-1992 (In million USD)(cont.)

	1986	1987	1988	1989	1990	1991	1992
G. Debt Rescheduling	8.60	45.90	11.90	20.30	15.83	10.67	
Interests	8.60	15.90	11.90		6.12	2.31	
Capital		30.00		20.30	9.71	8.36	
Cap Account -(A+B+C+D+E+F+G)	23.00	12.90	29.00	38.60	16.23	43.07	72.29
Repayment of Principal:							
Current Amortizations		2.07	0.78	1.96	1.39	1.37	0.66
Payments of Arrears		1.68	0.66	2.86	1.39	1.83	1.66

Source: Central Bank of Guinea-Bissau and unit of external debt at the Ministry of Finance

4.3. Aid and Exports

Table 4.3 shows the composition of exports during the period 1987-1992. The Table illustrates two characteristics of Guinean exports: firstly, there was no clear trend in the development of exports during this time; secondly, the country is highly dependent on exports of one product, cashew nuts, which accounts for more than 50 per cent of the total. The dependence on cashew nuts has increased since Independence because of a substantial reduction in the production of groundnuts, which ranked as a major export product until the mid-1970s. This long-term decline was caused by low world market prices. The former volumes of exports of groundnuts have not been recovered.

Marketed production of cashew nuts increased sharply between the early 1980s and 1990. Cashew nut exports increased from 2,300 tons in 1981 to 6,600 tons in 1985 and further to 16,409 tons in 1990[23]. The reliance on one product and one market (the bulk of Guinean cashew nuts are sold to India) has led to a high degree of dependence on the evolution of one price that is determined by factors beyond the control of the country.

23 IRDC (1987), p. 35 for 1981 and 1985 data; BCGB (1992), Table 7 for 1990 data.

TABLE 4.3. Exports 1987-1992 (In million USD)

PRODUCTS	1987	1988	1989	1990	1991	1992
Cashew nuts	10.9	9.0	7.1	11.6	14.1	3.0
Forestry	1.2	1.5	1.0	2.5	1.4	1.3
Fishery	0.5	0.9	2.2	3.3	2.6	0.8
Other	2.8	4.5	3.9	1.9	2.4	1.3
TOTAL	15.4	15.9	14.2	19.3	20.4	6.5

Source: Central Bank of Guinea-Bissau

There was also a significant fall in the exports of cashew nuts in 1992. The exports normally take place at the end of the year, but in 1992 they were delayed for several reasons. There is an export tax on cashew nuts and the tax rate has been reduced in several steps from 80 percent in 1987 to 25 percent in 1991. The fall in exports in 1992 is attributed to low world market prices and a disagreement between exporters and the government on the reference price to be used to calculate the tax payments. Discontent with the price established by the government and the world market price, the exporters chose to hold shipments. It is difficult to understand the logic in the behavior of the exporters because of high storage costs: it is estimated that 3 percent of the nuts are destroyed during each month of storage.

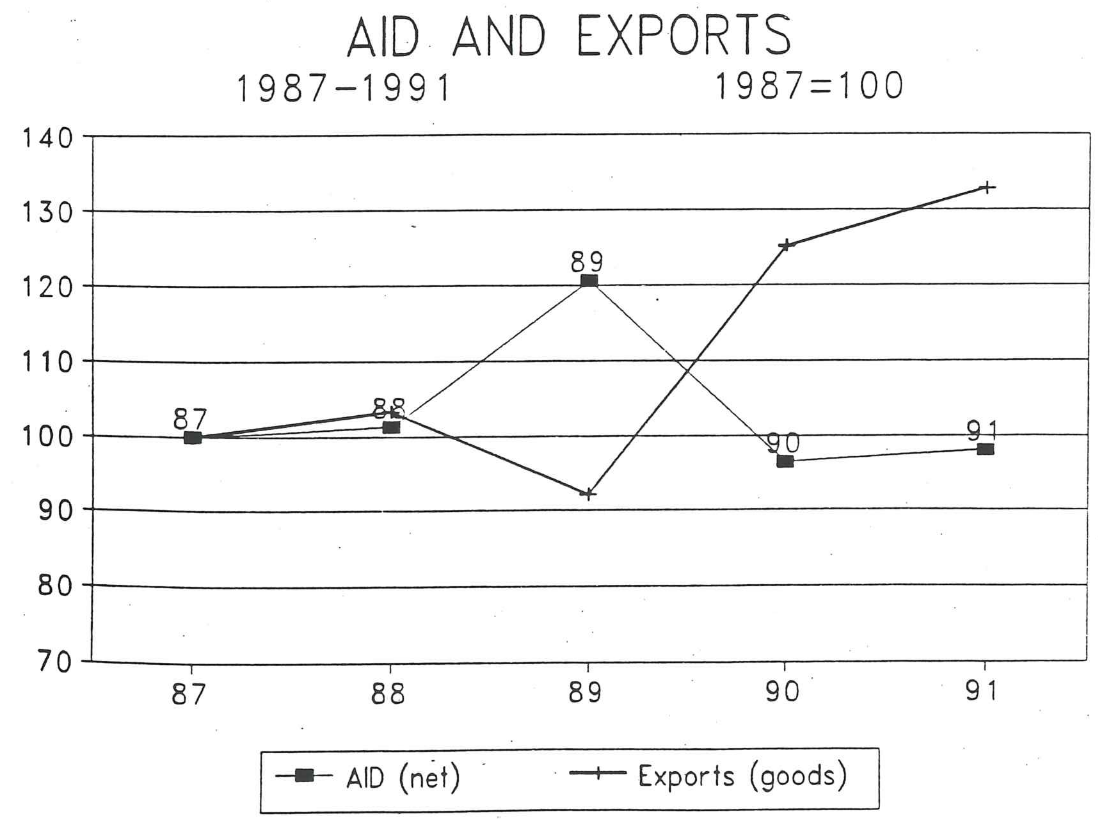
It is useful to note that the officially recorded statistics may not have captured all the changes occurring during the last few years. There is anecdotal evidence suggesting that informal export activities have increased much faster than what is implied in Table 4.3. For instance, casual observation suggests that there are increases in commercial fishing activities and forestry, but these exports take place in markets outside the control of the authorities.

The relation between aid and exports in the period 1987 to 1991 is plotted in Figure 4.1. The series starts in 1987, the first year for which data on net aid are available, and ends in 1991. We have not included 1992, because of the delays in the exports of cashew nuts which led to atypically low exports that year.

As Figure 4.1 shows, aid and exports developed in opposite directions between 1988 and 1990, but it is difficult to draw any clear conclusions from these few observations.

Exchange rate theory suggests that inflows of foreign resources may cause appreciations of the real exchange rate, RER (Edwards, 1989). The RER is a measure of the price incentives for the production of tradable goods. An appreciating RER lowers the relative price of tradables, which discourages production of exports and import substitutes, and encourages consumption of imports. Correspondingly, depreciating RER make exports relatively attractive and imports more expensive in local currency. One possible explanation for the negative relation between aid and exports suggested by Figure 4.1 is related to changes in the RER. The increase in aid inflows to Guinea-Bissau between 1988 and 1989 may have caused an appreciation of the real exchange rate, which depressed exports, and the subsequent reduction in aid inflows may have contributed to a real appreciation that has stimulated exports. It is therefore useful to look more closely at the relation between aid inflows and the RER.

FIGURE 4.1:



There are two main measures of real exchange rates in the literature. Recently, most studies have emphasized the comparison between local prices of nontradables, primarily services and labor, and the local currency prices of exports and import substitutes (Edwards, 1988). It is impossible to construct an accurate RER measure of this type for Guinea-Bissau, because the country produces only one price index, based on a basket of food products, beverages and tobacco. However, we have constructed a rough RER proxy on the basis of the price deflators that are implicit in the constant price series for exports and imports that are presented in the national accounts[24]. To construct this proxy, we first calculated prices indices for exports and imports using the price deflators from the national accounts. The export and import indices were then aggregated to an index for tradables, using the shares of exports and imports in goods trade between 1987 and 1991 as weights. The RER proxy is the ratio of this index to the consumer price index in Bissau. Table 4.4 presents the various indices for the period 1988-1992.

TABLE 4.4. Indices of Relative Prices and Net Aid Inflows 1988-92

	1988	1989	1990	1991	1992
Export Price Index	100.00	114.33	220.14	387.15	764.75
Import Price Index	100.00	180.74	252.28	404.78	782.56
a) Price Index Exports and Imports	100.00	166.33	245.31	400.96	778.70
b) Consumer Price Index	100.00	189.79	240.41	379.10	642.10
RER proxy (ratio a/b)	1.00	0.92	1.02	1.05	1.21
Net inflows of aid (index)	100.00	118.98	95.00	96.70	102.5

Note: The weights used to construct the price index for traded goods were 0.217 for exports and 0.783 for imports.

24 The price deflators used in the national accounts have been calculated on the basis of price information from various reports and sectoral studies.

A value of one for the real exchange rate proxy implies that there has been no change with respect to 1988. A value below one indicates an appreciation of the RER, as a result of a higher increase in the general price index than in the prices of tradable goods. The RER proxy suggests a real appreciation in 1989, the year in which the inflows of aid reached the highest level during the period studied. Since that year, however, there seems to be a steady depreciation of the RER, despite variations in the inflow of aid.

An alternative measure of the RER is given by the purchasing power parity real exchange rate (eppp). This compares the domestic and foreign prices of a representative basket of goods and services. The eppp is defined as

(5) $eppp = EP^*/P$

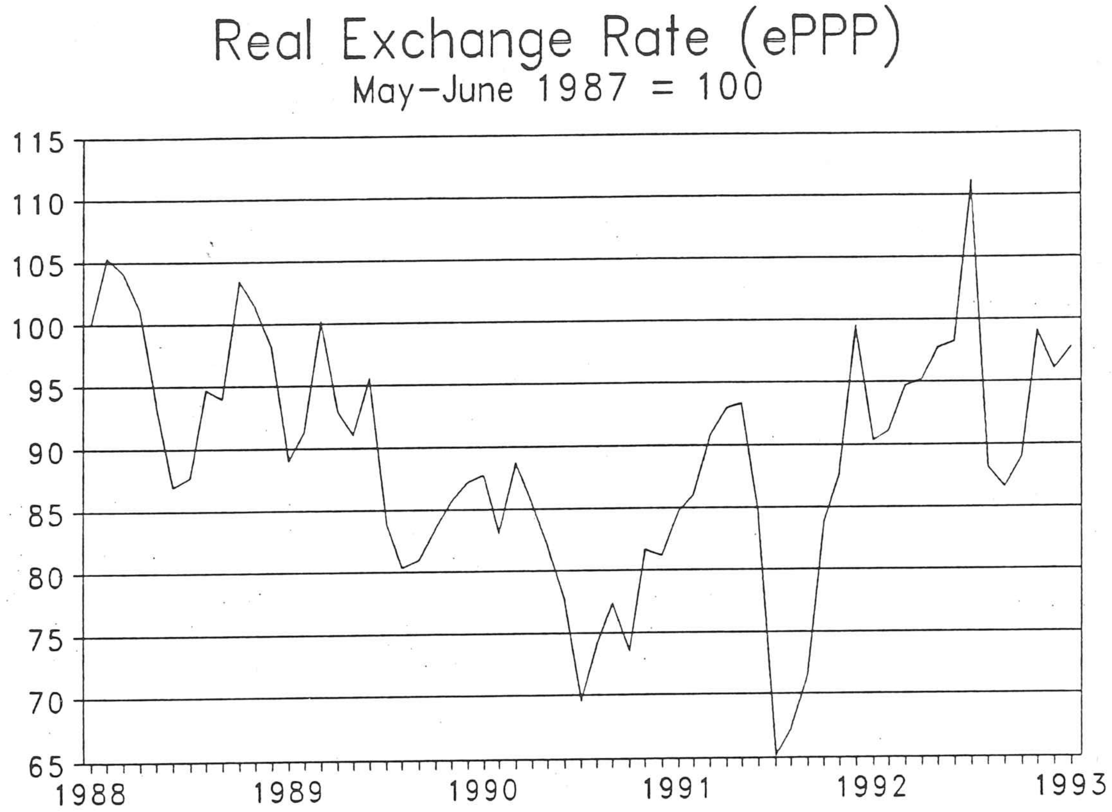
where E is the nominal exchange rate, P is the domestic price level and P^* is the foreign price level. Usually, the eppp is approximated by comparing changes in consumer prices in the national economy and its main trade partners. According to this measure, adjustments of the nominal exchange rate are necessary to keep the real exchange constant if there is an inflation differential between the country and the rest of the world. For instance, if domestic inflation is ten percent higher than foreign inflation, a ten percent devaluation of the nominal rate is necessary.

We have used a simplified version of eppp in our calculations. E is the nominal official exchange rate between the PG and the USD, P is the consumer price index in Guinea-Bissau and P^* is assumed to be constant[25]. In other words, we are not considering a multilateral exchange rate and we do not take into account the inflation in the USA, which introduces a small bias for appreciation. The evolution of the monthly eppp between 1988 and 1993 is illustrated in Figure 4.2.

The series is based on the value of the eppp in May-June 1987, immediately after a 60 percent nominal devaluation of the PG. It is impossible to assess whether this rate was an equilibrium value for the RER, in the sense that it would have supported an equilibrium between the supply and demand of foreign exchange in the long-run. Thus, our comments can only refer to changes in the RER with respect to the base value. An appreciation of the real exchange rate is shown as a fall in the value of the eppp index in Figure 4.2. The series shows a high degree of monthly variability and a tendency to the appreciation of the

25 Monthly inflation rates in the USA have been insignificant compared to those in Guinea-Bissau.

FIGURE 4.2:



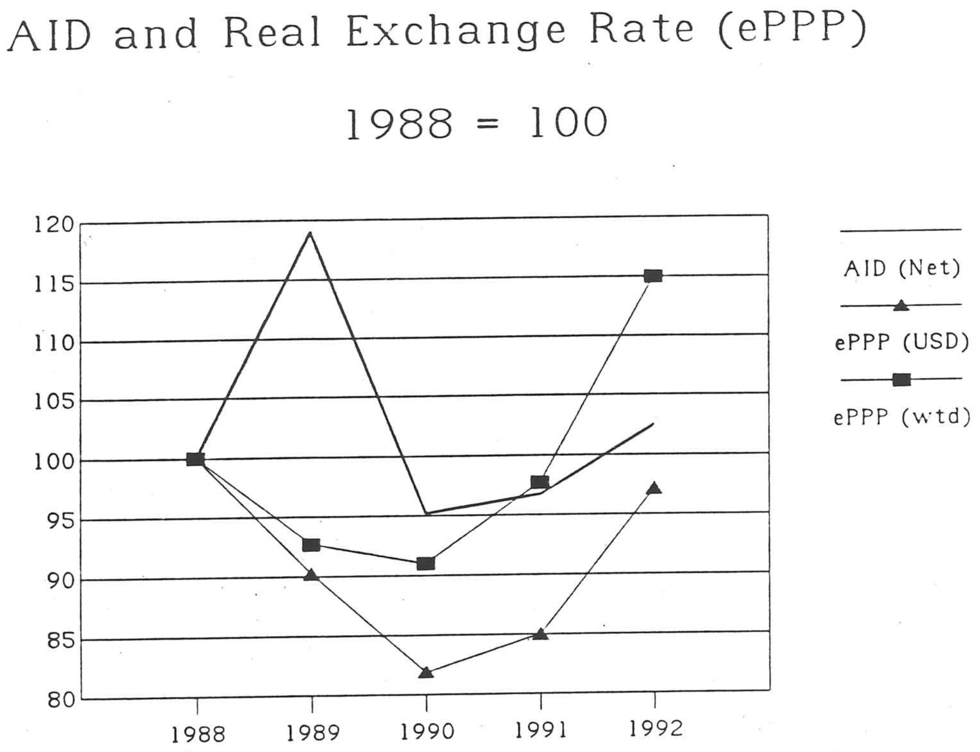
RER at the middle of each year. This reflects the monthly prices changes in Guinea-Bissau, with sharp variations. The series also suggest an effort to counteract the appreciation of the RER in subsequent months. The sharp appreciations of the RER in mid-1989, mid-1990 and mid-1991 also reflect increases in the monthly inflation rates because of large expansions of the domestic credit in those periods. In other words, large monetary expansion has caused high inflation, while exchange rate policy has tried to stabilize the RER. However, disregarding the monthly variations, the Figure indicates a tendency to an appreciation of the RER until mid-1991. Since then, it seems that the Central Bank has improved its capacity to manage the monetary and exchange rate policies. This is indicated by a clear depreciation of the RER during the first half of 1992, and by the fact that the

inflationary surge in August 1992 led to a smaller appreciation of the RER than in earlier years. Moreover, the RER was rapidly restored to a more appropriate value after this surge of inflation.

Figure 4.3 examines the relation between aid and two proxies for the eppp. The first eppp proxy is the bilateral real exchange rate against the US dollar. The second is a trade weighted multilateral real exchange rate. The main problem in constructing the proxies is to define appropriate weights for the different currencies that appear in Guinean trade, since smuggling makes up a significant proportion of transactions. The two proxies presented in Figure 4.3 therefore provide two extreme alternatives: the share of US dollars is 100 per cent in the first case, but only 4 per cent in the second case. Appendix Table 4.1 summarizes the data on nominal exchange rates, price indices, and trade weights used for the calculation of the multilateral real exchange rate[26]. The Figure suggests that there was a tendency to an appreciation of the RER in 1989 and 1990, and a steady depreciation thereafter. Moreover, there are no clear signs of appreciations being caused by inflows of aid. Rather, the increases in aid after 1990 have apparently been accompanied by a notable depreciation of the real exchange rate.

26 The trade weights are based on a trade basket for 1992, including countries with at least 5 per cent of Guinean imports or exports.

FIGURE 4.3:



The ability to avoid appreciation of the RER during recent years may be related to the requirement that the parallel exchange market premium must be kept below 20 percent. This has forced the monetary authorities to pursue active exchange rate policies. Given the expansionary fiscal and monetary policies that have led to high rates of inflation, the exchange rate policy has been forced to focus on frequent devaluations in order to avoid excessive appreciation of the real exchange rate. In other words, exchange rate policies have accommodated expansionary fiscal and monetary policies. Figure 4.4 illustrates the efforts to adapt official exchange rates to developments in the parallel market.

FIGURE 4.4:

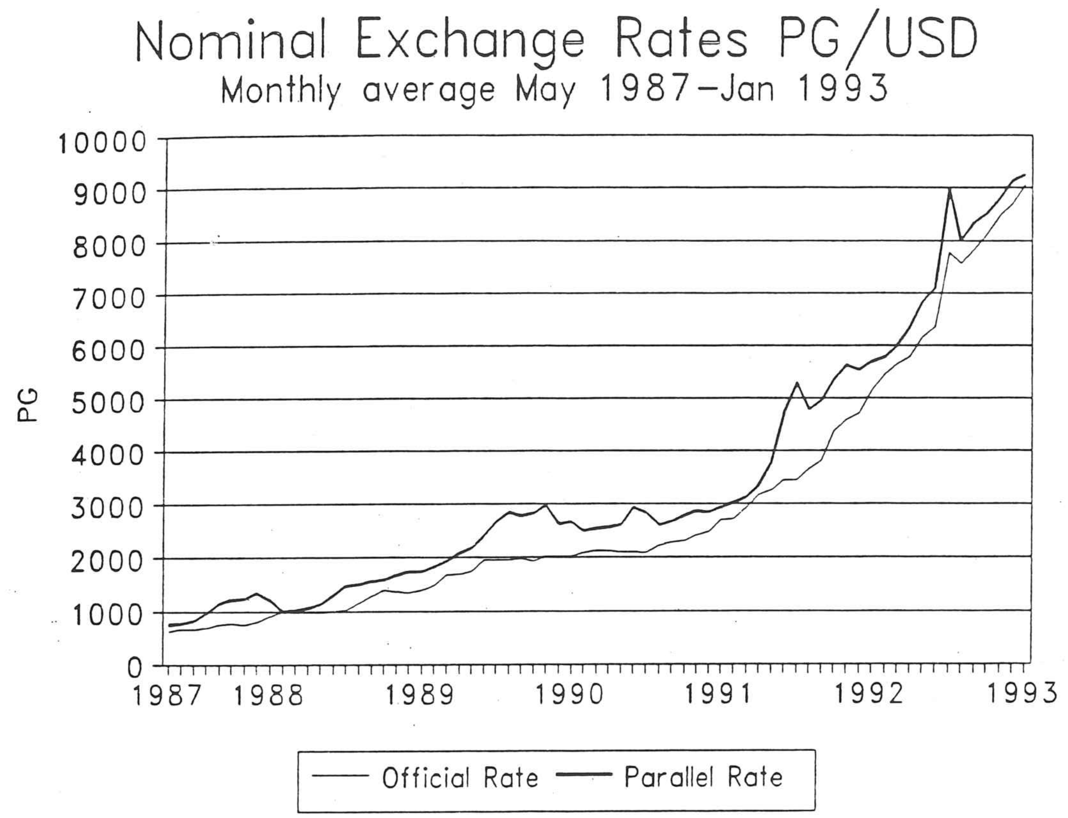
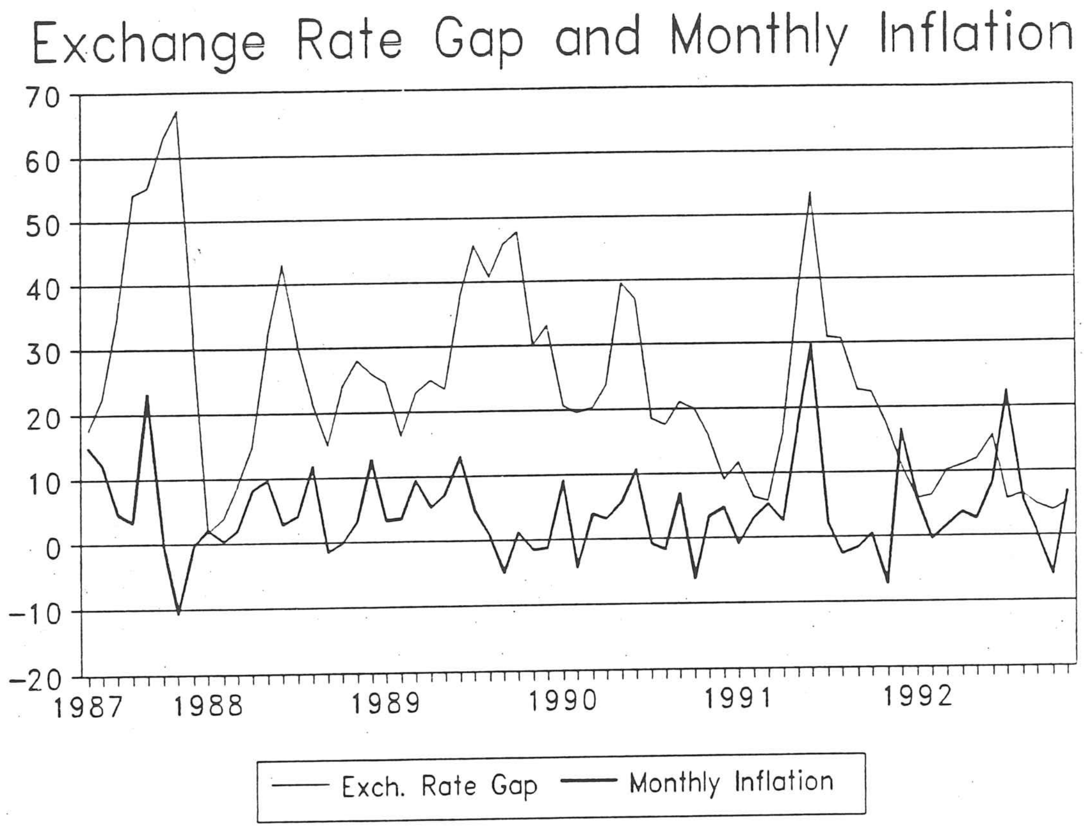


Figure 4.5 shows the gap between the official and the parallel exchange rates together with monthly inflation rates for the period 1987-1992. It can be seen that there has been a downward trend in the exchange rate gap since the end of 1989, which is related to the target of keeping the gap below 20 percent. The main exceptions occurred in connection with rapid increases in inflation rates in mid-1990 and mid-1991. Yet, the authorities have managed to reduce parallel market premium from over 40 percent in 1989 to around 10 percent during 1992. This pattern is consistent with the development of the monthly ePPP discussed above.

FIGURE 4.5:



To sum up the discussion about the real exchange rate, we have examined whether aid inflows may have caused an appreciation of RER and discouraged exports indirectly, but we found no such effects. On the contrary, an analysis of the exchange rate policies pursued indicates that the authorities have managed to avoid strong appreciations of the real exchange rate. Exports in Guinea-Bissau are characterized by a very narrow specialization in a small range of primary commodities. Still, after several years of structural adjustment, two thirds of exports are made up of cashew nuts. The period of structural adjustment reversed the downward trend in the volume of exports and witnessed a modest revival of the country's export production. Aid has not influenced exports significantly, neither directly through measures leading to a diversification and expansion of export production, nor indirectly through effects on the real exchange rate and thus on relative prices. This

is hardly surprising, since more comprehensive changes in exports would require significant changes in production structures, infrastructure, and human capital development. This type of changes can only come about in the long run.

4.4. Aid and Imports

The composition of imports during the period 1987-1992 is shown in Table 4.5. The aggregate value of imports has almost double since 1987, and imports of rice and other consumer goods has tripled. Rice, which is also produced domestically, makes up about 50 per cent of the imports of consumer goods. It is worth noting that passenger vehicles account for a large share of the imports of capital goods. Imports of fuels and lubricants, mainly gasoline and diesel, are certainly related to the rising imports of vehicles.

TABLE 4.5. Imports of Goods, 1987-1992 (In million USD)

	1987	1988	1989	1990	1991	1992
Consumption Goods	10.0	13.6	27.6	25.7	27.6	35.5
Rice	5.5	8.2	10.2	9.5	14.1	18.9
Other	4.5	5.4	17.4	16.2	13.5	16.6
Fuel and Lubricants	4.7	3.8	7.5	7.2	8.8	5.9
Capital Goods	14.8	21.4	18.6	24.2	26.3	32.2
Construction material	8.8	11.6	6.9	5.3	3.0	6.7
Other	6.4	8.6	8.4	5.8	1.9	3.2
Total	44.7	58.9	68.9	68.1	67.5	83.5

Source: Central Bank of Guinea-Bissau

It is easy to see that the Structural Adjustment Program has not reduced imports and that the structure of imports still has a strong bias towards consumption. It seems reasonable to expect an increase in the imports of consumer goods when an economy moves from a centrally planned system with a shortage of goods to a market-based system. Moreover, in the initial phase of the SAP, the promotion of production through an increase in the supply of imported incentive goods was an explicit aim. However, it is a matter of concern that this pattern is still present after several years of structural adjustment. The structure of imports, with a low share of capital goods, also reflects the low levels of private investment in Guinea-Bissau.

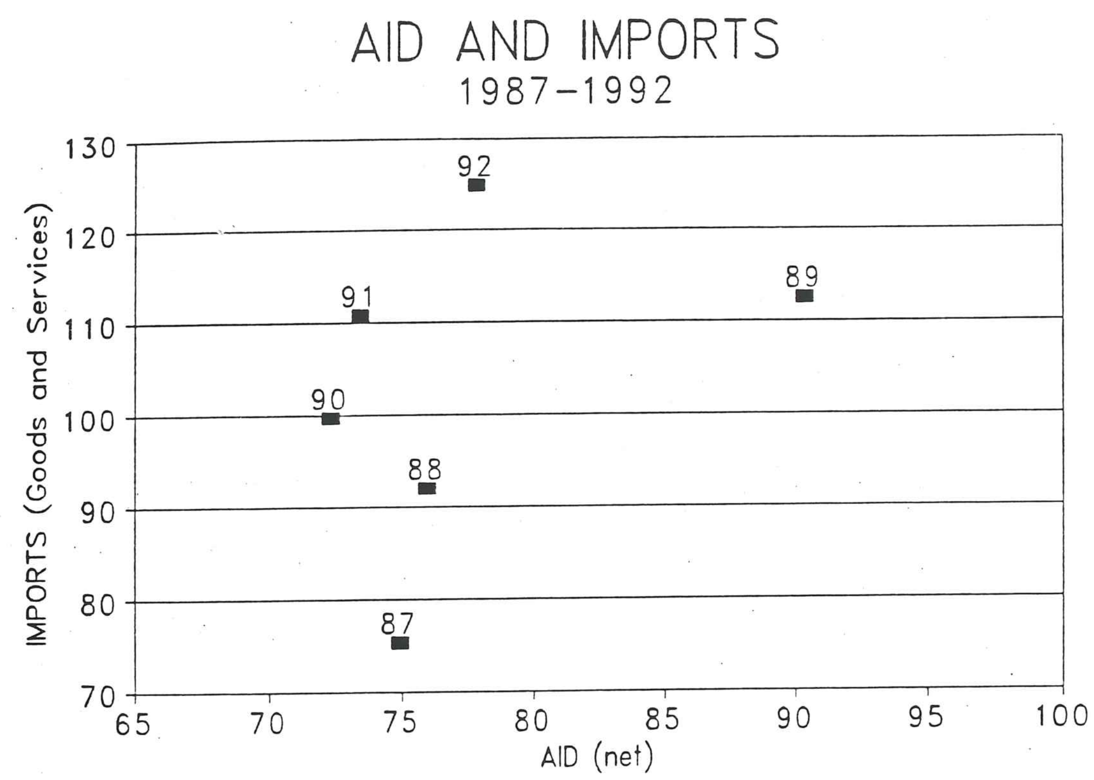
Figure 4.6 plots the relation between aid and imports. Unusually large aid inflows took place in 1989, and that year seems to be an outlier. There appears to be a positive relationship between the two variables, but the simple correlation between them is far from perfect[27]. Moreover, Figure 4.6 shows that imports have increased steadily and irrespective of what has happened with aid. It is impossible to disregard the fact that aid inflows determine the import capacity of the country and that aid financed projects account for a large share of the actual imports. However, there does not appear to be any exact relation between annual changes in aid inflows and imports.

Imports have increased steadily during the period, which suggests that there have been other sources of financing than inflows of aid and exports (it should be noted that exports revenues have covered less than a third of the import bill). For instance, there was a surge in imports in 1992, although exports fell markedly and no significant increase in aid inflows took place. According to the balance of payments, the import increase was financed with inflows of capital under the heading "Errors and Omissions and Short Term Capital". This suggests the existence of inflows of foreign exchange from unregistered sources, such as reexports of rice and larger exports of timber and fish than what is registered. The reexports of rice have been estimated at 40,000 tons in a recent report[28]. Thus, it is likely that the exports presented in the BoP of Guinea-Bissau are under-recorded, and that the resource gap is exaggerated. It is worth noting, however, that the extent of the imbalances would remain large even if the unrecorded exports were taken into account. Moreover, exports that take place outside the official channels are not taxed, which means that public revenue is lower than what it could be.

27 The simple correlation between aid and imports is 0.35 but statistically insignificant (0.30 excluding 1989).

28 Programme d'appui a la liberalisation du commerce des produits agricoles en Guinée Bissau, mimeo, FAO, Rome, February-June 1992.

FIGURE 4.6:



4.5. Aid and Other Components in the Current and Capital Accounts

The net factor payments recorded in Guinea-Bissau consist of two items: scheduled interest payments and payments for fishing licenses by foreign fishing fleets. Receipts from sales of fishing licenses are not affected by aid flows. Moreover, it is not possible to analyze the country's actual interest payments in detail, because these are not reported in the BoP. The series on interests payments can not be constructed since the available data on arrears and reschedulings of interest payments do not appear to be reliable for all years. For instance, in 1987 when scheduled interest payments were USD 8.3 million, the BoP report arrears on interest payments of USD 36.9 million and an additional rescheduling of interest of USD 15.9 million. It is difficult to imagine a situation where arrears are several times larger than scheduled interest payments.

Private current transfers (PCT) are a marginal item in Guinea-Bissau's BoP, and there is no apparent connection with aid inflows. We will not include any further discussion of PCT in the subsequent analysis.

Similarly, there is no apparent pattern between aid inflows and changes in reserves (dR). However, dR is a residual post that comes into play once other assets and liabilities have been accounted for. To discuss how accumulated reserves are used in more detail, we would need information about the Central Bank's foreign assets and liabilities. This information is not available. Moreover, until 1992 the Central Bank contracted loans abroad on account of the Treasury. The operations of the Central Bank and the Treasury were not reported separately, which makes the picture very unclear.

4.6 Internal and External Balance

We move now to the identity that equates the internal balance, i.e. the savings gap, and the current account. This can be expressed as:

(6) $GDS + NTR + NFP - I = X + NTR + NFP - M$ or

(6') $GNS - I = X + NTR + NFP - M$,

where GNS and GDS are gross national savings and gross domestic savings, I is investment and:

(7) $GNS = GDS + NTR + NFP$

According to White (1994), the orthodox view is that an increase in foreign aid, which is included in the term NTR, should be fully reflected in the current account as an increase in imports, and in the internal balance as a one-to-one increase in investments. To examine this relation empirically, it is useful to break down the savings-investment balance into those of the government and the private sector, so that

(8) $GNS_p - I_p + GNS_g - I_g = X + NTR + NFP - M$ or

(8') $GNS_p - I_p + T - G = X + NTR + NFP - M$

where subscript p denotes the private sector, subscript g denotes the government sector, and T and G are government revenues and expenditures. Grants received from abroad are included in government savings and revenues on the left-hand side, and on NTR on the right-hand side. Data on the national accounts are presented in Table 4.6, and they conform to the variables in eq. (8). We will first examine the relation between aid and investment, and then continue to look more closely at the impact of aid on the government budget.

TABLE 4.6. Data on national accounts 1986-1992 (In million USD)

	1986	1987	1988	1989	1990	1991	1992
GNP	230.32	162.95	150.55	191.66	245.62	230.14	220.91
NFI or NFP	0.90	-2.30	-4.40	-6.60	12.22	-3.55	0.25
GDP(M)	230.32	165.25	154.95	198.26	233.40	233.69	220.66
Exports of Goods and NF Services (X)	9.70	21.13	21.97	20.64	26.09	33.50	18.03
Imports of Goods and NF Services (M)	75.60	75.26	91.96	112.56	99.72	110.75	124.90
Resource Gap	-65.90	-54.14	-69.99	-91.92	-73.63	-77.25	-106.87

Source: BCGB (1993).

TABLE 4.6. Data on national accounts 1986-1992 (In million USD)(cont.)

	1986	1987	1988	1989	1990	1991	1992
C	236.66	164.38	171.95	222.19	249.48	247.66	269.02
C_p	205.17	143.00	154.10	194.68	221.62	216.33	245.50
C_g	31.49	21.38	17.85	27.50	27.86	31.33	23.52
I	48.87	55.01	52.98	67.99	57.55	63.28	58.50
I_p	0.00	6.51	2.59	3.35	5.73	6.00	1.02
I_g	48.87	48.50	50.39	64.64	51.82	57.28	57.49
GDS (GDP-C)	-6.34	0.87	-17.00	-23.93	-16.08	-13.97	-48.37
GNS (NTR+GDS+NFP)	-6.94	-3.43	-19.90	-29.33	-2.86	-21.66	-48.76
S_p		5.75	-10.55	-10.23	5.29	3.93	-29.52
S_g		-9.18	-9.36	-19.10	-8.15	-25.59	-19.20
NTR	-1.51	-2.00	1.50	1.20	1.00	-4.14	-0.64
CA (X+NTR+NFP-M)	-66.50	-58.44	-72.89	-97.32	-60.41	-84.94	-107.26
OT	43.50	45.60	44.00	58.20	44.16	39.96	35.69
CA incl OT	-23.00	-12.84	-28.89	-39.12	-16.25	-44.98	-71.57

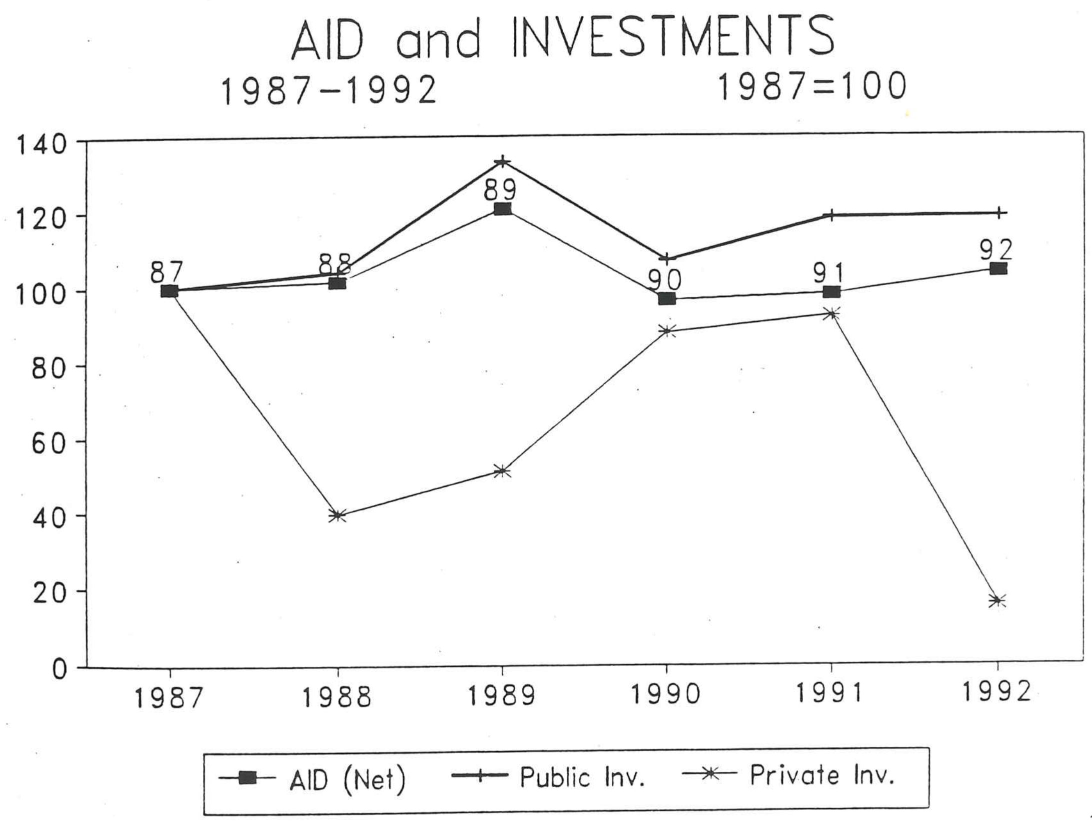
Source: BCGB (1993).

4.7 Aid and Investments

Figure 4.7 plots the development of aid, public investments and private investments. There appears to be a positive relationship between aid and public investments, but not between aid and private investments.

Historically, aid-supported investment projects fall under the public sector and more than 95 percent of the investments included in the public investment programme (PIP) are financed by grants and concessional loans[29]. Even the domestic financing comes mainly from funds that have been generated through the inflow of aid (counterpart funds directed to the FND, Fundo Nacional de Desenvolvimento).

FIGURE 4.7:



Although the structural adjustment program initiated in 1986 emphasized the need to reduce the size of the PIP and to promote private investment, the data in Table 4.6 show no downward trends in public investments. The SAP also aimed to reorient the composition of the program towards the provision of basic infrastructure in support for production and

29 The simple correlation coefficient between aid inflows and public investments is 0.79 and it is statistically significant at 6 percent level.

exports. However, the intended changes were difficult to realize. One problem was the lack of priorities and coordination between projects. Already during the period 1983-1986 there were attempts to establish priorities in the PIP. During this period, the sectoral composition of public investment spending changed markedly and the share of public investment directed towards industry fell from 21 percent in 1979-1982 to 5 percent in 1983-1985. Within industry, emphasis was shifted from capacity building to the rehabilitation of existing facilities. Yet, investments projects were not supported by careful appraisal studies, because the local managerial resources were insufficient. Instead, the PIP had the character of a list of projects created on the basis of donor priorities: the availability of foreign finance was the main criterion for project selection.

The SAP proposed a plan for the reduction of public investment from USD 71 millions in the 1986 investment budget to about USD 48 millions in 1987, and the reorientation of expenditures to allocate 50 percent of resources to physical infrastructure, 25 percent to directly productive sectors including agriculture, and the remaining 25 percent towards social infrastructure[30].

At the beginning of the 1990s, the PIP was still an incomplete list of ongoing projects about which the State Secretariat for Planning, responsible for its administration, lacked detailed information. Furthermore, a very large proportion of the expenditures included in the program were recurrent costs and expenditures for technical assistance. In the last years, however, the government has managed to establish a more efficient administrative system, which has reduced the number of projects, and promoted investments in infrastructure. Particularly since 1992, there has been a noticeable improvement in the planning and implementation process. The share of machinery, equipment and construction in the PIP increased from 39 percent in 1989 to 52 percent in 1992, while the number of projects fell from 234 to 128. The number of projects in agriculture fell from 56 to 38, as intended. Projects in energy, transport, telecommunications, and other public works and regional development increased their share from 23 to 42 percent.

As mentioned before, aid given as investment support has been one of the major determinants of the level of investment, with donors financing not only the foreign exchange costs but also local costs. In fact, this is a situation that will probably persist for several years, since the government lacks the resources necessary to cover local costs. As an example, suppose that the investment expenditures were reduced to half, and that the local

30 WB (1987), pp. 24-33.

financing increased to reach 10 percent of the new expenditures. This would require local resources equivalent to one third of tax revenues in 1992, an amount that is not available given the present budgetary situation. In the absence of well-functioning domestic capital markets, the government cannot but obtain those resources through borrowing from the Central Bank, increasing money supply. This is no attractive alternative. In the long-run the solution is to expand the tax base, i.e. to mobilize domestic resources for investment purposes. In the short-run, however, foreign investment support must take into account the limited financing capacity of the local authorities. This argument is similar to that discussed by Doriye, White and Wuyts (1993, pp. 57-58) for the case of Tanzania.

In the absence of sufficient domestic resources to cover local costs, the other alternative open to the government is to refuse project aid. However, it seems unrealistic to expect that type of reaction from the local authorities, given that they lack the capacity to assess projects, rank them according to priority, and select the projects to be refused. This implies that the responsibility for a more restrictive investment policy lies in the hands of the donors.

There are also other reasons, apart from lack of domestic resources, that favor a reduction in the size of the investment program. High levels of investment have expansive effects, leading to high levels of import demand, not only because of the import content of investment projects but also through the demand multiplier. It can be argued that the multiplier effects are smaller when the import content of investment projects is high, as in the case of Guinea-Bissau with its narrow production structure. However, the multiplier effects cannot be ignored even in such cases, as discussed by Doriye, White and Wuyts (1993, p. 59).

Although the policies have managed to create some improvements in the public investment program, there are many remaining problems. Most importantly, Guinea-Bissau still lacks the domestic capability to undertake careful appraisal and feasibility studies, which means that it is difficult to fulfill any priorities. A related problem is that an important share of investments is financed by loans, and the inability to assess project-specific rates of returns means that there are probably projects that will not generate sufficient direct or indirect returns to provide for repayments of loans and interests. A third problem is that the public investment program is still too large in relation to the managerial and entrepreneurial capabilities of the economy. The PIP still accounts for 26 percent of GDP and the marginal investment funds would probably be more efficiently used elsewhere in the economy. For instance, investments in human capacity development would probably yield higher returns than those obtained in some of the ongoing investment projects.

Private sector investments have been limited for several reasons: weak financial institutions, lack of domestic managerial capacity, unstable macroeconomic environment and so forth. However, private investment accelerated between 1983 and 1985, according to a comprehensive World Bank study, to reach 2.4 percent of GDP (about USD 3.6 million) in 1985[31]. This was the result of an increase in the area under cultivation in large farms (*pontas*) and the transfer of state retail stores to the private sector. In the series for the period 1987-1992 there is no clear trend suggesting further increases in private investment. The lack of any clear trends is partly due to the fact that the aggregate numbers are heavily influenced by a few large commitments, which leads to a high variability in the data.

4.8. Aid and the Government Budget

Because of its small and underdeveloped private sector, Guinea-Bissau's public sector dominates the economy. The public sector expanded rapidly during the years after Independence. Table 4.7 summarizes the structure of the government's budget since 1987. Unfortunately, there is no information on the distribution of expenditures by sector or ministry, so it is not possible to make any detailed analyses of the social policies of the government.

31 WB (1987), p. 37.

TABLE 4.7. The Fiscal Budget 1987-1992 (in million USD)

	1987	1988	1989	1990	1991	1992
A. Revenue	**68.10**	**65.01**	**81.81**	**88.63**	**71.39**	**55.50**
A.1 Tax Revenue	**14.13**	**13.11**	**8.49**	**18.90**	**15.38**	**8.69**
A.1.1 Income Taxes	1.64	1.35	2.03	3.38	1.90	1.65
A.1.2 Property taxes	0.03	0.04	0.04	0.01	0.00	0.00
A.1.3 Consumption taxes	1.49	1.91	1.23	2.84	3.48	1.82
A.1.4 Int. Trade taxes	9.67	8.98	4.29	11.49	9.13	4.51
Import taxes	2.57	3.20	2.93	3.00	3.70	1.79
Export taxes	6.08	4.40	0.01	5.55	3.10	0.82
Custom duties	1.02	1.39	1.35	2.94	2.33	1.90
A.1.5 Other taxes	1.31	0.83	0.90	1.18	0.88	0.71
A.2 Non-tax Revenue	**8.37**	**7.89**	**15.12**	**25.47**	**18.35**	**12.81**
A.2.1 Fishing licenses	6.64	5.70	13.45	22.85	16.42	11.71
A.2.2 Other	1.73	2.20	1.67	2.63	1.93	1.10
A.3 Extraordinary	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**2.80**
A.4 Grants	**45.60**	**44.01**	**58.20**	**44.26**	**37.66**	**31.20**
B. Expenditures	**80.18**	**80.75**	**107.35**	**104.35**	**116.59**	**100.98**
B.1 Current Expenditures	**29.68**	**25.85**	**39.50**	**38.30**	**47.05**	**34.04**
B.1.1 Salaries	9.65	7.56	9.85	9.92	12.00	8.67
B.1.2 Goods and Services	8.88	8.29	14.08	14.58	15.32	11.65
B.1.3 Transfers	2.85	2.01	3.58	3.36	4.02	3.20
B.1.4 Interests	8.30	8.00	12.00	10.44	15.72	10.52
B.2 Capital Expenditures (PIP)	**48.50**	**50.39**	**64.64**	**51.82**	**57.28**	**57.49**
B.3 Net Loans	**2.00**	**4.50**	**3.21**	**14.22**	**12.26**	**9.45**
Government surplus						
incl. Grants	-12.08	-15.74	-25.55	-15.71	-45.21	-45.48
excl. Grants	-57.68	-59.75	-83.74	-59.97	-82.87	-76.68
Primary saldo						
(A - A.4 - B.1 + B.1.4)	1.12	3.15	-3.89	16.51	2.4	0.78
Change in:						
external arrears (interests)	-14.60	7.10	11.00	1.84	8.98	7.56
internal arrears	0.00	0.00	0.00	0.00	0.00	3.69
Global Adjusted deficit						
(after adjustments)	**-23.82**	**-13.08**	**-15.09**	**-17.56**	**-30.58**	**-34.23**

TABLE 4.7. The Fiscal Budget 1987-1992 (in million USD) (cont.)

	1987	1988	1989	1990	1991	1992
Financing	23.82	13.08	15.09	17.56	30.58	34.23
Domestic Borrowing	**-18.38**	**-16.04**	**-14.50**	**-14.86**	**-7.30**	**4.22**
Banks excl. Counterp.	-17.07	4.82	17.06	23.92	-0.58	6.11
Counterpart funds	0.00	-13.14	-26.09	-8.33	-6.72	-1.89
Non-bank	-1.31	-7.72	5.47	-30.44	0.00	0.00
Net Foreign Borrowing	**42.20**	**29.12**	**29.60**	**32.42**	**37.88**	**30.01**
Disbursements	33.10	33.41	37.00	30.12	36.70	32.41
Amortization	-14.50	-15.20	-27.70	-18.36	-31.22	-30.18
Change in arrears	-22.30	-0.98	0.00	4.83	21.73	27.78
Debt Rescheduling	45.90	11.90	20.30	15.83	10.67	0.00

Source: OGE (1993)

The government has been running a large budget deficit in recent years. The primary budget saldo, defined as revenues (excluding grants) minus current expenditures (excluding interest payments), is often used as an indicator of how expansionary or contractionary the government's economic policies are. In Guinea-Bissau, the primary balance has been positive but insufficient to generate resources to pay interests on the external debt. In other words, it is hard to characterize the government's fiscal policies (excluding the PIP) as overly expansionary.

A large increase in tax revenues in 1987 was followed by a period of a steady decline, to a very low level in 1989. Tax revenues recovered in 1990 but declined again during the following years. For the whole period, they have fluctuated in real terms.

Low income countries are usually heavily reliant on international trade taxes, while domestic income taxes tend to be of more limited importance. Guinea-Bissau is no exception and most tax revenues are from taxes on international trade. The effective tax burden on imports can be calculated using budget data. They indicate that the average effective import tax is about 5 percent, i.e. lower than the average tariff on imports, which

suggests the existence of widespread tariff exemptions[32]. The average effective tax on exports fell from almost 40 percent in 1987 to about 15 percent in 1992. Export taxes are still an important source of tax revenues. Although the country´s trade deficit would seem to require even stronger export promotion, the role of export taxes for fiscal revenues limits the possibility to reduce them further in the short run.

Consumption taxes, which include a tax on gasoline, account for a small share of tax revenues. There is a potential for increasing them, as the efforts in 1990 and 1991 show, but policies were not sustained in 1992. Non-tax revenues are mainly made up of fishing licenses, which have become a major source of foreign exchange earnings. The revenues from fishing licenses in 1990 are unusually high due to renegotiations and payments of licenses for earlier years. It is clear, however, that fishing receipts doubled since 1987, which may reflect an improvement in the negotiating skills of the government. The extraordinary revenues are from the privatization of public enterprises. Grant aid is accounted for on the revenue side of the budget with amounts corresponding to those reported in the balance of payments.

The most important policy reforms related to the revenue side of the budget are a simplification and a rationalization of the tax structure and a broadening of the tax base. The facts that transactions in small and medium firms are not recorded, and that the educational system does not provide the necessary skills to maintain formal books and records, limit the possibilities to extend the tax base in the short run. Thus, the largest potential for an increased base is the elimination of various exemptions from existing tax legislation. Several initiatives have been taken to improve the administration and collection of taxes and to rationalize the tariff structure and improve custom procedures[33]. There are, however, several measures that have not been undertaken yet, such as the introduction of a broad based consumption tax, land taxation and increasing the number of new tax payers.

Real current expenditures were stable in 1987 and 1988, increased markedly in 1989 and have fluctuated since then. There is no clear trend suggesting a reduction of expenditures. Salaries account for about a quarter of current expenditures. The government has

32 The average unweighted tariff was lowered from 29 percent in 1989 to 24.3 percent in 1990, and the dispersion of the tariff rates was reduced. However, the tariff structure presents many inconsistencies, with, for instance, similar products taxed at different rates (see WB, 1992).

33 The World Bank has prepared a thorough study of Guinea-Bissau's tax policy and tax administration, and proposed measures to improve the efficiency and equity of the tax system (see WB, 1992).

implemented retirement plans and other measures to reduce public sector staffing. Two censuses of civil service personnel were carried out in 1989 and 1992 as steps in the implementation of rationalization plans.

The capital expenditures included in the government budget are largely made up of the PIP, and are still high, especially with respect to the World Bank recommendations that the investment volume should be reduced. The expenditure side is complemented with the item Net Loans. This is an adjustment item that collects information on delays in the payments of counterpart funds generated by some types of grants. We can see an important increase in delays in 1990, but the government increased its efforts to recover the loans in 1992 and 1993. The IMF reports that most of the debtors are now identified[34].

Table 4.8 presents several measures to illustrate the character of fiscal policy in Guinea-Bissau. As mentioned before, the primary balance has been positive, but since it does not generate sufficient resources to pay for capital expenditures and interests on the external debt, the country shows large overall deficits. Part of these deficits are financed by inflows of grants, but the country has substantial financing needs even when these inflows are accounted for. Moreover, the reduction in the inflow of grants in recent years has led to an increase in the global deficits. These deficits are financed by net inflows of capital in the form of loans, and by debt management through debt reschedulings and accumulation of arrears.

It is important to note that major elements in the fiscal budget, such as grants and net foreign borrowing, are factors outside the control of the Guinean authorities. Thus, the possibility to control the budget deficit by influencing domestic variables is limited. For instance, a doubling of tax revenues would not reduce the global deficit by more than 25 percent. The major entry among expenditures, the PIP, is largely determined by donor preferences, as we have discussed earlier.

In summary, it is hard to see any substantial improvements in the fiscal budget, as could be expected from the ongoing adjustment process. Tax and tariff reforms, privatizations and stricter management of counterpart funds have been implemented, but they have not left any significant marks on the budget deficits.

34 IMF (1992), p. 17.

TABLE 4.8. Fiscal Indicators 1987-1992 (percent)

	1987	1988	1989	1990	1991	1992
Tax Revenue/GDP	8.6	8.5	4.3	8.1	6.6	3.9
Grants/GDP	27.6	28.4	29.4	19.0	17.1	16.2
Curr. Revenue/Curr. Exp.	75.8	81.2	59.8	115.9	71.7	63.2
Revenue (excl. Grants)/GDP	13.6	13.6	11.9	19.0	14.4	11.0
Current Exp. / GDP	18.0	16.7	19.9	18.2	20.1	15.4
Capital Exp. / GDP	29.3	32.5	32.6	22.2	24.5	26.1
Primary Saldo/GDP	0.7	2.0	-2.0	7.1	1.0	0.4
Global Deficit/GDP:						
incl. Grants	-7.3	-10.2	-12.9	-6.7	-19.3	-20.6
excl. Grants	-34.9	-38.6	-42.2	-15.3	-35.5	-34.8

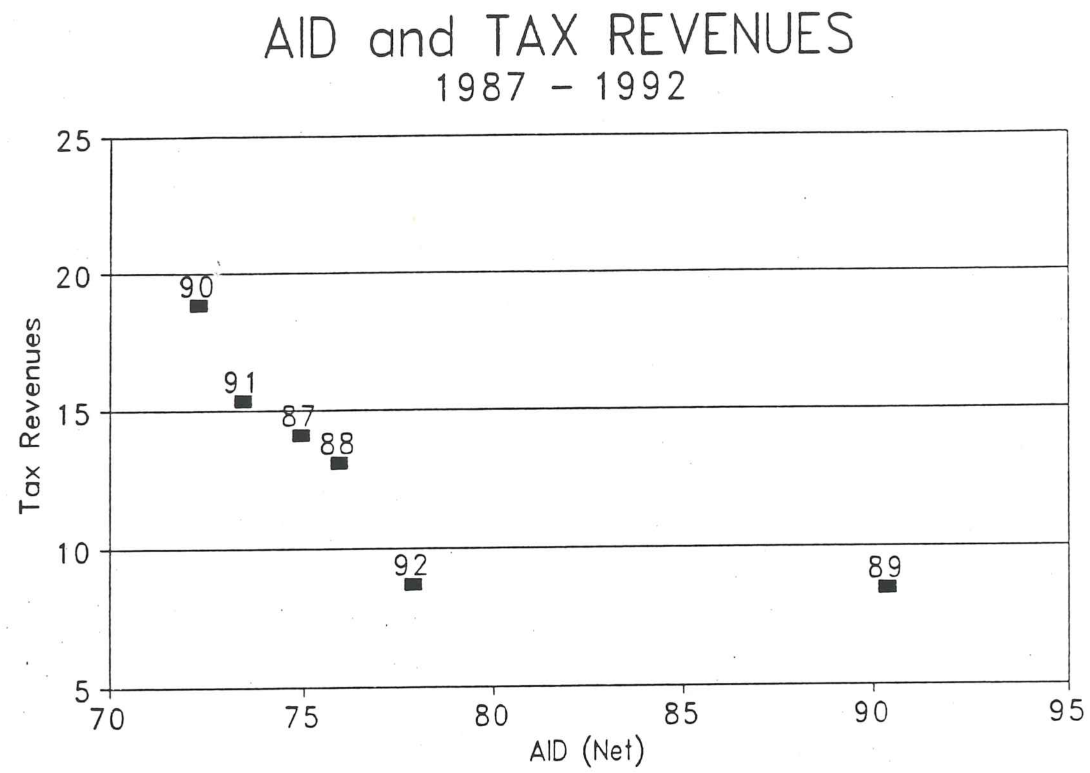
Source: OGE (1993), Ministry of Finance.

An analysis of the relationship between aid inflows and the elements on the revenue side of the budget indicates that there is no strong relationship between aid inflows and total revenues. This result seems reasonable, since receipts from fishing licenses are a major element in the fiscal revenues and they are the result of factors not directly related to aid policies, such as the government's negotiating skills, the fishing needs of other countries, and the willingness of those countries to pay for the fishing permits. We found, however, a clear negative relationship between aid inflows and tax revenues, as illustrated in Figure 4.8. The figure indicates that tax revenues tend to fall when there are increases in aid inflows[35]. Moreover, the relationship holds for both major components in tax revenues: consumption taxes and taxes on international trade. In other words, it seems that there is aid fungibility in the sense that increases in aid inflows during the period 1987 to 1992 have allowed the government to reduce domestic taxation.

Turning to the expenditure side, we have already mentioned the fact that the capital expenditures are financed almost completely by aid monies. We found no clear relationship

35 The simple correlation coefficient between tax revenues and net inflows of aid is -0.77 and it is statistically significant at 7 percent level.

FIGURE 4.8:



between current expenditures and net aid inflows. Finally, aid inflows seem to have a negative influence on the primary budget saldo, but the effect is not statistically significant and it operates through the effect on tax revenues.

APPENDIX TABLE 4.1. Data used for calculation of multilateral real exchange rate

	Germany	Portugal	Holland	Senegal	China	Gambia	USA	GBissau
Consumer Price Index (P* and P)								
1987	100.10	100.00	100.00	100.00	100.00	100.00	100.00	100.00
1988	101.40	109.57	100.70	98.13	120.70	111.69	103.97	160.62
1989	104.20	123.40	101.81	98.62	140.38	120.94	108.99	290.35
1990	107.00	139.85	104.33	98.92	142.35	135.73	114.85	386.10
1991	110.70	155.73	108.35	97.15	149.57	147.36	119.77	608.49
1992	115.20	169.64	112.37	97.05	160.82	161.38	123.37	1032.05
Exchange Rates against PG - period averages (E)								
1987	353.46	3.97	275.95	1.86	150.18	79.02	559.00	
1988	623.49	7.71	561.57	3.73	298.22	165.45	1110.00	
1989	1066.09	11.49	853.49	5.67	480.73	238.63	1810.00	
1990	1462.52	15.33	1199.96	8.03	456.81	277.18	2185.00	
1991	2413.59	25.33	1957.00	12.97	687.34	415.65	3659.00	
1992	4296.16	51.36	3943.13	26.20	1257.39	780.15	6934.00	
E.P*/P								
1987	353.82	3.97	275.95	1.86	150.18	79.02	559.00	
1988	393.62	5.26	352.09	2.28	224.11	115.05	718.54	
1989	382.60	4.89	299.28	1.93	232.43	99.40	679.42	
1990	405.31	5.55	324.23	2.06	168.42	97.44	649.97	
1991	439.09	6.48	348.47	2.07	168.95	100.66	720.22	
1992	479.55	8.44	429.35	2.46	195.94	121.99	828.87	
Trade Weights (w)								
1992	7.41	48.40	17.30	9.40	11.90	1.70	3.88	

CHAPTER V

SUMMARY OF FINDINGS AND RECOMMENDATIONS FOR SWEDISH AID

5.1. Summary of Findings

The period under Portuguese rule led to the emergence of a dual economic structure in Guinea-Bissau, with a distinct gap between a formal sector dominated by the colonial authorities, and a large informal sector comprising most of the indigenous population and the bulk of economic activities. The formal economy was organized around a bureaucratic public sector that controlled markets through various types of regulations and administratively fixed prices. Manufacturing was limited to a small and oligopolistic industrial sector, and the few inefficient firms survived only thanks to protection from foreign competition. The demand from the expanding colonial authorities was instead mainly satisfied by imports, and large trade deficits were built up. These deficits were financed by capital inflows from Portugal, and a sizeable foreign debt was accumulated. The policies with respect to the informal sector aimed to capture as much of the peasant production as possible, as reflected by rules stipulating compulsory harvesting and deliveries of export crops. However, the government's control did not extend to other activities in the informal sector.

The system of central planning established immediately after Independence did not end this duality. Instead, the command economy adopted much of the structure that had emerged during the colonial period. The state apparatus remained at the center of the stage, regulations and administrative pricing were maintained, the oligopolistic markets did not become more competitive, and the informal sector stayed outside the realm of official authorities. Trade deficits persisted and foreign debt continued accumulating, but the financing changed from Portuguese capital transfers to inflows of foreign aid from the international donor community.

With hindsight, it appears clear that the main obstacles to economic development during this period were the lack of institutions supporting efficient markets and economic growth. The formal sector was inefficient, both because its losses were more or less automatically covered by inflows of foreign resources and because competition was restricted by import protection and barriers to entry. Factor mobility was limited for several reasons. Most importantly, price incentives were not used to allocate resources to the most efficient activities, and there was a lack of confidence in the official institutions. Why should people participate in formal sector activities and be taxed by the government if the resources would only be used to support bureaucrats and monopolistic public firms? These fundamental weaknesses were exacerbated by more acute problems at the beginning of the 1980s, when the burden of debt accumulated and the official markets stagnated. In addition, lack of technological capabilities, shortages of skilled labor, and non-existent capital markets contributed to retard development.

The structural adjustment program instituted in Guinea-Bissau after the mid-1980s signalled an abrupt change in the direction of the development strategy. The new policies differed markedly both from the colonial past and from the centralized system instituted after Independence, and emphasized the need to create institutions that promote markets rather than bureaucratic decisions, to establish prices that reflect supply and demand, to reduce the market power of monopolistic firms and traders, to increase efficiency in production as well as public administration, and to establish some degree of macroeconomic stability.

The sequencing of reforms was such that adjustment began with a comprehensive liberalization of markets and prices, to be followed by measures to improve and develop the institutional framework. Macroeconomic stabilization was intended to occur more or less simultaneously with liberalization. Hence, the first phase of the adjustment process, up to 1989, focused on exchange rate flexibility, export incentives, and reductions in import protection. Reforms of tariff and tax systems, financial markets, and government finances received more attention during the second phase of the program.

Liberalization and deregulation managed to stimulate a range of economic activities that were limited in scope or even forbidden. However, the increase in the level of activity is not fully reflected in official statistics, since much of the expansion has taken place in informal markets. For instance, the level of activity in the street markets in Bissau has grown significantly since the mid-1980s, and there have been marked increases in the supply of goods in rural areas.

Many institutional changes have also taken place as a result of the adjustment program. For instance, a central bank and the first two private commercial banks have been established, the government's budget management has been improved, and fiscal reforms have reduced overstaffing in the public bureaucracy. Moreover, a population census has been completed, and a household survey is planned. Although these elements of the reform program have little direct effect on the economy, they indicate a change in the administrative process. Earlier, policy was conducted without much information about its effects; the improvement in the availability of information makes it possible to identify the effects of various changes in the economy, and to pursue more conscious stabilization policies and reforms.

It is also important to note what the structural adjustment reforms did not aim to achieve. For instance, it was clear that it would not be possible to balance the trade accounts or the government budget in the short or even medium run. It was not only necessary to service the large debts that had accumulated over the preceding decade, but it was also understood that the development strategy required higher resource inputs than what Guinea-Bissau could mobilize domestically. Hence, the fact that the country still exhibits large trade deficits and budget deficits are not necessarily signs of policy failures: however, the fact that these deficits have not shown any signs of reductions after the first years of reforms is worrying.

The adjustment process has met with difficulties in some other areas as well. The weakest performance has probably been recorded in monetary policy, where the authorities have allowed high credit expansions, both to the government and to the private sector. The credits to the government have been used to cover the budget deficit, whereas credits to individuals and commercial firms have largely been used to finance imports. One of the consequences has been high inflation.

The inability to control the rate of inflation has hampered the efficiency of several aspects of the adjustment program. The impact and efficiency of the reforms depend on attaining and maintaining relative prices that reflect economic scarcities. These relative prices are strongly influenced by inflation, because the rates of price changes are not uniform across all goods and services. Thus, inflation results in unstable relative prices and disturbs the information that the prices are intended to convey to economic agents. This way, high inflation reduces the efficiency of the price system and disturbs the link between changes in resource allocation and price changes. High inflation and price volatility generate uncertainty about future prices and promote activities with quick returns. These activities are likely to have a lower impact on long-term growth.

Another weakness has been the inability to expand government revenues. It has proved difficult to expand the tax base, since the informal sector still accounts for a large share of economic activities. Furthermore, the results of the customs and tariff reforms, which were expected to increase public revenues, have been disappointing.

A key aspect of fiscal adjustment concerns the level, composition, and management of public investment. The scarcity of funds suggests that Guinea-Bissau should economize on the available resources, cut down the magnitude of public investment, and give priority to projects with the highest rates of return. The absence of a systematic process for evaluating public investment projects makes this impossible. The reason is a lack of skills to plan, evaluate, and monitor the public investment program. However, it should be noted that there have been some improvements in the PIP as well: the number of projects has been reduced, which is likely to improve also the efficiency of the program, and higher share of the resources have been invested in infrastructure.

Some of the remaining obstacles to sustainable development are easy to identify. One serious problem is the low mobility of production factors, which means that changes in economic structure and production will be small in the short run even if the government manages to establish correct price incentives. The low price elasticities are related to, for instance, unclear ownership of land, which discourages people to invest in land management; low skills in the labor force, which constitute bottlenecks for some types of activities, even if price incentives are present; and inefficient financial markets, where credit instruments and practices are particularly unsuitable for small and medium scale enterprises. Another serious problem is the lack of competition, especially in the small industrial sector and in wholesale trade. Since the market in Guinea-Bissau is too small to sustain more than a few individual firms in many industries, it appears that import competition is the most efficient way to avoid some of the problems related to monopolies and oligopolies. However, tariff revenues are still among the most important items in the government budget, and the weaknesses in fiscal management are therefore intimately connected to this problem as well. This is also related to a third obstacle to development, which is the weak institutional capacity of Guinea-Bissau. Apart from firm commitment to restructuring and reforms, the country must possess the local institutional capacity for economic and financial analysis and for the formulation of policy advise, so that the reform program can be carried out. In Guinea-Bissau, this capacity is limited to a very small number of local experts, many of whom have been educated and trained during the course of the recent adjustment programs.

As a summary assessment of the adjustment programs that have taken place since the mid-1980s, it seems fair to claim that Guinea-Bissau has succeeded in liberalizing the economy - that is, the reforms have managed to remove some institutions that obstructed development - but that the authorities have not been equally successful in creating a stable macroeconomic environment or establish new institutions in all areas where such are needed. As noted earlier, it is necessary to establish clear ownership rules of land, a more efficient legal system, improve the education and health care, and so forth. In this sense, the experience of Guinea-Bissau is comparable to that of many other developing countries undergoing similar structural adjustment programs (Mosley, Harrigan and Toye, 1991). Moreover, the lack of macroeconomic stability has given the entire program a bias in favor of rent-seeking and fast profits. The volatility of relative prices has encouraged speculative investments rather than investments in productive capacity. Firms and individuals who have managed to secure credits for imports of consumer goods, and who have received land concessions, have earned more profits than those involved in productive activities. Consequently, the policies have to some extent taught the actors to seek this type of rents.

The international development agencies, mainly the World Bank, have played an active role in the reform process, by contributing to the design of the adjustment programs and by providing financing and technical assistance for the implementation of the programs. Both these elements have been necessary elements of the reforms. As noted several times, Guinea-Bissau lacks the skills and technical capacity to design, implement, and assess comprehensive reform programs. Furthermore, external financing has been a precondition for the type of reforms that have been launched, since it allows adjustment with somewhat higher levels of consumption and investment than would otherwise be possible, and makes difficult measures more acceptable. For instance, the liberalization phase required inflows of foreign aid in order to finance necessary increases imports of investment goods and incentive goods.

Regarding the direct effects of aid inflows on other macroeconomic aggregates than imports, it is very difficult to see any distinct pattern. (In fact, not even imports seem to be very sensitive to short-run fluctuations in aid inflows.) One reason is of a practical nature: detailed data series can only be constructed for the most recent years, and neither the number of observations nor the variability in aid flows is large enough to allow firm conclusions about effects. Another reason is that the fundamental reorientation of development strategies during the mid-1980s has probably changed many of the processes that determine the relationship between aid and various macroeconomic aggregates. It would therefore be difficult to make useful generalizations even if the data to construct longer time series were available.

Hence, it is not surprising that short-run changes in aid inflows have no apparent effect on the level of exports, the real exchange rate, or any other of the variables that appear in the country's external balance, i.e. the current and capital accounts. However, looking at the impact of aid on the internal balance, it is possible to make some slightly more confident conclusions. As we have noted several times, there is a fundamental connection between aid and public investment, since public investment is largely financed by aid monies. Our empirical data reveal that there is also a short term correspondence between the two: the volume of public investment fluctuates closely with aid inflows. Yet, the most significant result from the empirical analysis was a negative relationship between aid inflows and the government's tax revenues, which suggest that there has been aid fungibility. In other words, inflows of aid funds to the government has allowed it to lower the domestic tax burden, which suggests that aid has substituted for domestic mobilization of resources.

This is a sign of weak fiscal discipline and supports the findings regarding the performance of the adjustment program at large: the main weaknesses appear to be a lack of fiscal and monetary discipline.

Another aspect of the effects of aid is related to aid dependence. According to Doriye, White, and Wuyts (1993, pp. 50-51), "sustainable growth without long-term aid dependence requires that the average savings ratio rises over time so as to close the savings gap" and that "export growth should exceed import growth in a longer run perspective". Regarding the latter definition, it is difficult to say anything about how aid inflows influence Guinea-Bissau's aid dependence: short-term fluctuations in aid have not been closely related to changes in imports and exports. However, looking at the former definition, it appears that aid has actually worsened aid dependence. Lacking data on the informal sector, we must interpret the savings-investment gap in terms of government revenues and expenditures, where public investments are included. Our results suggest that there is a negative relation between aid inflows and government tax revenues. Since there also appears to be a positive relation between public investment and aid, this indicates that aid actually widens the savings gap, and aggravates aid dependence.

5.2. Recommendations

It is clear that an exogenous inflow of foreign resources, like development aid, may distort some prices, like the exchange rate. It is sometimes argued that this is detrimental to development because aid will, ceteris paribus, lead to an appreciation of the real exchange rate, allow the country to import more than what would otherwise be possible, and reduce the incentives for local production. However, it is necessary to be very cautious before this type of conclusion is used as a basis for policy recommendations, because the alternative to an aid-distorted external sector is not always free trade and an exchange rate that is determined by the forces of demand and supply.

If free trade could be guaranteed, elimination of aid would most certainly lead to a sizeable devaluation: the high demand for imports would probably continue for some time, the supply of foreign currencies would be significantly smaller, and the combination of the two would lead to increases in the price of foreign currencies. However, there is no guarantee that this is what would happen in the absence of foreign support to a transition program. The reason is that devaluations of this magnitude are not always politically feasible. The typical response to a foreign exchange crisis in the developing world has instead been to tighten administrative controls, in order to allocate scarce foreign exchange to the uses that are deemed most worthy (WB, 1988). A reaction of this type is inimical to adjustment programs that emphasize the importance of prices and market mechanisms. More generally, it is possible that local authorities would be much less committed to structural adjustment programs without aid financing. In fact, inadequate funding has been a major reason for policy reversals in countries undertaking structural adjustment (WB, 1988, p. 6).

Hence, it should be obvious that a complete elimination of aid can not be recommended if a continuation of the reform program is desired. This does not imply that foreign funds should finance the entire adjustment process. On the contrary, policies directed to mobilize domestic resources and increase the efficiency of resource use are absolute requirements for sustainable development. Changes in the amount and types of aid may, however, be warranted. It has been noted above that the structural reforms have progressed far when it comes to liberalization, but not when it comes to stabilization and institutional development. Furthermore, the stock of foreign debt makes up a serious constraint for development. Furthermore, the stock of foreign debt makes up a serious constraint for economic development: some share of already scarce resources must be channeled for debt servicing. One main recommendation is that the allocation of aid resources should focus more closely on stabilization and institutional development. In addition, efforts to alleviate the overhanging debt burden should be considered. It should be noted already here that the recommendations that follow are based on a macroeconomic perspective, which means that they may have to be complemented by measures focusing more directly on specific target groups.

From the point of view of economic stabilization, it appears that the present structure and level of imports in Guinea-Bissau are inappropriate. Firstly, imports contain too much consumer goods. The reason is that the incentives for long-term productive investments in Guinea-Bissau have been weak, and imports and wholesale and retail trade have provided faster and less risky profits than production of goods. The Central Bank's slack credit policies have made financing of imports easy, but the resulting credit expansion has contributed to the high level of inflation. Thus, it is likely that a bias towards trading activities in a country with oligopolistic markets and loose credit policies will not contribute to economic stability, and that lower levels of imports of consumer goods would be more appropriate. Secondly, the total investment volume reflects too high levels of investments with respect to the country's management capability. Consequently, many investments have not been profitable enough to cover interest payments and amortizations, which have instead burdened the government budget, and worsened the budget deficit. Hence, badly managed and inefficient investment projects do not support economic stability, which suggests that the investment amounts should be reduced to a more manageable level.

Aid resources should be allocated in a manner that supports stabilization. At a general level, this means that the donor's commitment should be of a long-term nature, and that volatility in aid disbursements should be avoided. More specifically, it appears that macroeconomic stability in Guinea-Bissau would benefit from lower levels of aid. A reduction of the imports of consumer goods would improve the conditions for local producers; a reduction of imports of capital goods would improve the efficiency of the public investment program. It is also likely that aid donors could support stability by making aid disbursements conditional on attainment of specific macroeconomic targets. Most importantly, it appears necessary to reduce credit expansion and inflation. Given the nature of the Guinean economy, it appears obvious that inflation cannot be eliminated altogether, but a target for price stability is called for. Without further analysis, it is impossible to determine what is an acceptable rate of inflation, but a reduction of the rate and perhaps also the volatility should be possible. Moreover, specific targets regarding government revenues may be necessary to avoid the fungibility of aid funds that appears to be present.

Regarding institutional development, it is apparent that the most acute constraint to development is the lack of technical skills and management capabilities in the public sector, as well as in the emerging private sector. Hence, aid should focus heavily on education and training of local personnel.

Improvements in the management capabilities of the ministries and public institutions related to social sectors, e.g. education and health, are at the top of the list, since their operations are essential for the future success of efforts to improve the country's human capital resources. In fact, it appears that the insufficient managerial capabilities in the areas of health and education have been the major constraints to achieve sustainable improvements in the standard of living of the population. The weak results obtained so far cannot be attributed to lack of foreign resources, but to the low efficiency with which they are used. Another reason to focus on management capabilities in these areas is provided by Doriye, White, and Wuyts (1993), who demonstrate that poverty alleviation does not necessarily follow from economic growth. Instead, improvements in the health and educational status of the poor are necessary to enhance their possibilities to benefit from economic growth.

To support emerging private sector and the development of markets, it is also necessary to invest in market infrastructure, and establish well defined property rights and an efficient legal system. Foreign support is also needed for the establishment of appropriate credit institutions, such as rural credit markets and credit facilities for small and medium sized firms.

Meanwhile, it is necessary to combine long-term programs focusing on these institutions with short-term training programs targeting key groups of technocrats elsewhere in the economy. In the private sector, there is need for simple vocational training in mechanics and electronics, and basic skills required in a market economy, such as accounting and book-keeping. In the public sector, the focus should be on support to key institutions in the reform process: the central bank, the ministry of commerce and trade, and the ministry of finance and its planning secretariat. Continued support to data collection and production of statistics would also enhance the capabilities to formulate and evaluate ongoing and future economic reforms. In particular, there is presently a lack of information on issues like poverty, income distribution, consumption patterns, and other household data.

Some of the short-run requirements, especially in the public sector, could perhaps be satisfied by financing expatriate experts to be stationed at the relevant ministries, which has been the traditional approach. However, we would like to promote other alternatives. The transfer of skills to locals must be the central objective, and it is likely that this is achieved more efficiently (and probably also at a lower cost) if local personnel are given intensive training courses in Guinea-Bissau or elsewhere.

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