AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

COUNTRY FOCUS REPORT 2024

SÃO TOME AND PRINCIPE

Driving São Tome and Principe's Transformation

The Reform of the Global Financial Architecture

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ABBREVIATIONS

AfDB	African Development Bank
ADF	African Development Fund
AfCFTA	African Continental Free Trade Agreement
BCSTP	Central Bank of Sao Tome
BISTP	Banco Internacional de São Tome and Príncipe
CDN	Country Diagnostic Note
CEMAC	Central African Economic and Monetary Community
COVID-19	Coronavirus Disease
CPIA	Country Policy and Institutional Assessment
CST	Santomean Telecommunications Company
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
ECCAS	Economic Community of Central African States
EEZ	Exclusive Economic Zone
EMAE	Empresa de Água e Eletricidade (Water and Electricity Company)
ENCO	Empresa Nacional de Combustíveis e Óleos (National fuel and Oil Company), SARL
ETISP	Energy Transition and Institutional Support Program
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
GBV	Gender-Based Violence
GEF	Global Environment Facility
GFA	Global Financial Architecture
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GIABA	Inter-Governmental Action Group against Money Laundering in West Africa
GoSTP	Government of São Tomé and Príncipe
ICT	Information and Communications Technology
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
INDC	Intended Nationally Determined Contributions (INDC)
INPGEE	The National Institute for the Promotion of Gender Equality and Equity
JDZ	Joint Development Zones
LULUCF	Land Use, Land-Use Change and Forestry

MDB	Multilateral Development Bank
MTDS	Medium-Term Debt Management Strategy
MIC	Middle-Income Country
MSME	Micro, Small, and Medium-sized Enterprises
NDC	Nationally Determined Contribution
NPL	Non-Performing Loan
ODA	Overseas Development Assistance
PFM	Public Finance Management
PPG	Public and Publicly Guaranteed
PPPs	Public-Private Partnerships
PV	Present Value
SSA	Sub-Saharan Africa
SIDS	Small Island Developing State
SDG	Sustainable Development Goal
SDR	Special Drawing Righs
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprise
STP	São Tomé and Príncipe
STN	Sao Tomean Dobra
UNIDO	United Nations Industrial Development Organization
USD	United States Dollar
VAT	Value Added Tax
WTO	World Trade Organization

EXECUTIVE SUMMARY

1. **The African Development Bank (AfDB) Group's Country Focus Report (CFR) 2024 for São Tomé and Principe (STP) aims to analyse** the country's main and recent economic developments, challenges and underline the need to restructure the international financing system to support the country's transformation, development and growth.

2. **STP's recent economic performance has been modest, with an average annual growth rate of 1.4% between 2019 to 2023. However, growth rates, while still positive, have been on a downward trajectory since 2016, except for 2020 and 2023 when economic growth was higher than in the preceding years**. Although STP's economy grew at a modest pace of 1.4% annually from 2019 to 2023, economic growth was only 0.1% in 2022 and was estimated at 0.5% in 2023, mainly due to the lingering impact of Covid-19, power disruptions, and Russia's invasion of Ukraine[1], which led to higher food and oil prices on global markets. STP imports 100% of its fuel (90% of its electricity generation is diesel-based) and half of its food needs.

3. **STP's economy has experienced some structural changes since 1990, but it is not sufficiently diversified into manufacturing and other high-value sectors**. Its main development challenges have remained largely unchanged since 2018. The country's overarching development challenge is the limited production base that hinders economic diversification and a more inclusive and higher growth trajectory for sustainable poverty reduction, weakening the country's resilience to economic and climatic shocks. The economy is dominated by low-productivity activities in agriculture, fisheries, and trade, which have limited STP's growth potential. STP's main development challenge is compounded by several underlying development challenges such as weak institutional capacity, low skill levels, poor business environment, inadequate infrastructure, and unsustainable energy sources. The country's remoteness and insularity also result in high trade and production costs, especially for the island of Principe.

4. **To address STP's most pressing development challenges, the country should invest heavily in expanding its production base and building a more diversified and resilient economy that can overcome insularity, move towards high value production and create decent employment.** However, to achieve this goal the country will need high levels of investment to rebuild its infrastructure and reform and modernise its public sector. According to the country's According to the country's Long Term Strategy (Agenda 2030), STP currently needs around USD 1 billion for infrastructures.

5. The Country Focused Report (CF) 2024 will be structured in 3 chapters, namely Chapter 1, Macroeconomic performance and outlook, Chapter 2, Taking stock of the country's structural transformation and progress, and Chapter 3, Financing structural transformation in Sao Tome and Principe.

INTRODUCTION

STP is a Portuguese-speaking island nation, located in an archipelago of islands about 350 km off the western equatorial coast of Central Africa in the Gulf of Guinea. The country is made up of two main islands (São Tomé and Príncipe), and several rocky islets (Rôlas, south of São Tomé Island, Caroço, Pedra and Tinhosas, south of Príncipe). It is divided into seven administrative districts, six on São Tomé Island and one on Príncipe Island. STP's territory consists of about 1,001 square kilometers, making it the second smallest and second least populous sovereign state in Africa after Seychelles.

STP's geographical location and remoteness present both opportunities and challenges for its development. The country has a rich biodiversity (including virgin rainforests and pristine beaches), and a distinctive volcanic landscape, which make it attractive for nature-based tourism and niche agricultural production. STP has potential for tourism development, thanks to its cultural heritage and colonial architecture. Its exclusive economic zone (EEZ), which is 160 times larger than its land area, offers potential for marine activities such as fisheries, aquaculture, coastal tourism, biotechnology and renewable energy. However, the country shares many of the challenges and vulnerabilities common to Small Islands Developing States. Its economic activity is undiversified and dependent on external sources of funding and trade. The country is also vulnerable to the negative impacts of climate change and natural hazards. It is characterised by high costs and low access to regional and global markets, as well as a large and young population that needs more human capital and employment opportunities. Moreover, one of the main constraints to agriculture in STP is the lack of sufficient fertile land, which represents only 9 percent of the total land area. The mountainous landscape of the islands restricts crop production. Additionally, the country's small size and population hinder its diversification potential, affecting its growth and development performance, reducing economies of scale, and increasing the demand for public expenditure. Moreover, STP has limited human capital and institutional capacity, which affect its productivity and competitiveness.

Despite being a lower-middle-income country (MIC) with a Gross Domestic Product (GDP) of USD540 million and a GDP per capita of approximately USD 2,468 in 2023, São Tomé and Príncipe has a fragile economy and high vulnerability to external shocks. The country's fragility stems from fiscal vulnerabilities, climate risks and poor business environment, including energy availability. STP relies heavily on external aid and government borrowing from bilateral and multilateral institutions, as its domestic revenue collection is weak. The country also faces challenges in its business environment, climate resilience and reliability of energy supply, which hamper private sector development. These factors make the country vulnerable to external shocks such as the COVID-19 pandemic and Russia's invasion of Ukraine. The COVID-19 pandemic revealed the country's vulnerability in terms of trade, social infrastructure, and health system. Following this introduction, Chapter 1 of this CFR evaluates STP's macroeconomic performance and outlook, Chapter 2 discusses the STP structural transformation progress, while Chapter 3 presents the external financing which the country needs to achieve structural transformation while dealing with the threat of climate change.

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MACROECONOMIC PERFORMANCE AND OUTLOOK

KEY MESSAGES

- **STP's recent economic performance has been modest, with an average annual growth rate of 1.4% from 2019 to 2023.** STP's positive economic outlook comes with cautious optimism given the considerable global uncertainty and geopolitical tensions.

- **The power sector's dependency on fossil fuel is likely to continue in the next few years due to the investment needed to transform the sector.** Moreover, the poor business environment, especially the unreliable energy supply, and lack of investment in key economic infrastructures could hamper growth in the medium term.

- **Persistent inflationary pressures may put further pressure on the country's economy by further lowering real wages and keeping interest rates high for longer period**. This could affect private sector investments in the economy.

- **To reduce external vulnerabilities and improve the fiscal position, the government should enhance revenue collection by reforming tax policy and administration, broadening the tax base, and minimising tax exemptions**. These measures are essential to support economic recovery and address the fiscal challenges.

- **STP should continue to implement policies aimed at strengthening the dobra/euro parity.** However, to maintain its currency peg to the euro, STP needs a strong fiscal position and structural reforms to boost its external competitiveness and avoid external imbalances. Some of the key reforms should focus on diversifying STP's economy to increase exports and on improving the efficiency of the electricity company to lower oil imports, and thus enhance the external balance.

1.1. Introduction

This chapter presents an updated analysis of the country's economic performance for 2023, including growth projections the period 2024-2025. It also assesses trends in such areas as key macroeconomic indicators, fiscal and monetary policies, and changes in domestic and international financial flows, investment, and public debt. The chapter also discusses the main downside and upside risks to the outlook and provides policy options to foster high and resilient growth; support macroeconomic stability and economic transformation, and address the shocks that have continued to buffet the country's economy.

1.2 Growth Performance

STP's recent economic performance has been modest, with an average annual growth rate of 1.4% between 2019 to 2023. However, growth rates, while still positive, have been on a downward trajectory since 2016, except for 2020 and 2023 when economic growth exceeded the levels for the preceding years. STP's economy has not been able to create enough jobs and diversify its productive sectors. The agriculture, forestry and fisheries sectors contracted by 3% on average from 2019-2023. This contraction was mainly attributed to low-technology production methods, outdated agricultural techniques and practices, high costs of inputs, as well as intermittent poor weather conditions, and global trade disruptions. The country's main growth drivers during the 2019-2023 period were the service and industrial sectors, with average growth rates of 2.7% and 3.1%, respectively. In 2023, the industry sector is estimated to have grown by a robust 6.4%, thanks to private investments in agro-processing and beverages, while the services sector is estimated to have grown by 4.4% due to a gradual recovery of global trade. However, the aggregate GDP growth rate is estimated to be modest in 2023, with 0.5%, this was mainly due to the prolonged impact of the power disruptions on the economy, exacerbated by Russia's invasion of Ukraine, which led to a rise in global food and oil prices. STP depends entirely on imports for its fuel needs, as 90% of its electricity generation is diesel-based.

STP's economy suffers from a limited production base that hinders economic diversification and reduces the country's resilience to economic and climate shocks. As a result, the country is unable to achieve a more inclusive and higher growth trajectory for sustainable poverty reduction. These challenges have been aggravated by the adverse effects of the impact of the COVID-19 pandemic and Russia's invasion of Ukraine. STP's geographical remoteness also increases its trade and production costs, particularly for the island of Principe due to its "double insularity".

1.3 Other Recent Macroeconomic and Monetary Policy and Inflation.

The Central Bank of STP (BCSTP) has maintained a prudent monetary policy stance since 2018 in pursuit of macroeconomic stability. Amid higher inflation risks, the BCSTP tightened its policy stance in late 2020 to mop up excess liquidity and lower the non-performing loan (NPL) ratio in the banking system. It raised the interest rate from 9% to 10%, the liquidity interest rate from 9.5% to 10.5% and the minimum cash reserve ratio for local currency deposits from 18% to 28% between 2020 and 2022. These measures were intended to counter the combined effects of the COVID-19 pandemic and Russia's invasion of Ukraine -, which pushed up global oil and food prices, fuelling the domestic inflation in 2022. Annual inflation, rose sharply to 25.2% at the end of 2022 from 9.5% in 2021, mainly due to external factors such as supply shocks and global demand, as STP still depends heavily on imported fossil fuels for power generation and food imports for about half of its food needs. However, inflationary pressures have subsided since the beginning of 2023 as the BCSTP's tighter policy stance begins to bear fruit and the effect of international food and fuel prices decline. The yearly inflation rate declined to 17% in December 2023.

Fiscal policy. STP faced a structural fiscal deficit that averaged 4.5% of GDP during 2019-2023, driven by a narrow tax base, a large wage bill and a high demand for public investment. Fiscal revenue was estimated to stand at 15.8% of GDP in 2023, up from 11.7% in 2022 due to the government's commitments under the IMF's 40- month Extended Credit Facility (ECF) programme approved in October 2019. The low revenue ratio is due to the small tax base and weak tax administration. Domestic revenue collection (DRC) is thus weak, with the tax-to-GDP ratio at 15%, below the sub-Saharan average of around 20%. In response to the narrow tax base and low revenue, the Government introduced the value-added tax (VAT) in June 2023 at a standard rate of 15% and 7.5% for the primary food basket. The VAT will help the Government to collect more revenue. Meanwhile, total public expenditure was estimated at 34.5% of GDP in 2023 from 31.2% in 2022. Most of the expenditure is allocated to the large public wage bill and investments. Staff cost represented 47.4% and 52% of primary costs in 2022 and 2023 respectively, while investments accounted 26.9% and 29.5% of total expenditure in 2022 and 2023, respectively. As a result of low revenue and high expenditure, the country continues to face a recurrent fiscal deficit, which was estimated at 4.2% of GDP in 2023, compared to 6.2% in 2022. The recent decline in the deficit is due to the containment of total government expenditure. The country's fiscal deficit is bridged by grants and loans from multilateral and bilateral partners.

Public debt: Total public debt averaged 103% of GDP in the period 2018-2022. Public debt declined to 104.6% of GDP in 2022 from 107.9% of GDP in 2021 (Fig. 3,). In 2022, external debt declined to 50.8% of GDP from 60.2% in 2021, while domestic debt stood at 17.2% in 2021 and 18% in 2022. The overall decline in public debt was due to country's access to grants and the imposition of limits on commercial loans. The reasons for then persistently high public debt are the narrow tax revenue base and high public expenditure, both for current and capital expenditures. Moreover, the energy sector depends heavily on imported fossil fuel. The average annual fuel import bill for power generation is USD 36.3m per year, representing 8% of GDP. The national water and electricity company (Empresa de Aguas e Electricidade- EMAE) is unable to meet the fuel supply costs of ENCO's i.e. STP's main fuel importer 'Empresa Nacional de Combustiveis e Oleo') EMAE's debt to ENCO accumulated to USD 178.3 million in 2022, representing 35.3% of the total public debt. In 2023 the Government was forced to contract line of credit of USD 30 million, of which USD 12 million was drawn to respond to the fuel supply crisis. Nonetheless, concessional loans account to the bulk of public debt.

External position and external financial flows: The current account deficit has been persistent, averaging 15.7% of GDP over the past five years to 2023. It peaked at 21% of GDP in 2019 before declining to 11.8% in 2020 amid the COVID-19 crisis. The reduction was mainly driven by increased external assistance from development partners (DPs). Aid inflows increased by 77% from USD 27.5 million in 2019 to USD 48.7 million in 2020. However, the current account deficit widened again in 2022 and 2023 to 14.5% and 13.6% of GDP, respectively. The country faces a major challenge in ensuring its energy and food security, as it is heavily dependent on external sources for both. This puts considerable pressure on the country's foreign reserves. The country's Net International Reserve (NIR) has been relatively stable over the past decade, averaging USD 39.7 million, equivalent to 3-4 months of imports. However, in the past two years, the NIR experienced a sharp decline, from USD 29.9 million in 2021 to USD 0.51 million in December 2023, covering less than a month of import.

Social Developments: STP faces challenges in the areas of education, skills and employment. According to the UN Human Development Report (HDR) 2019, the multidimensional poverty rate fell from 40.7% in 2008 to 11.7% in 2019, thanks to better performance in child mortality, school attendance, sanitation, electricity, and housing access. The report reveals that between 2008 and 2019 deprivation levels declined significantly in most dimensions from 4.4% to 0.8% (child mortality), 12.1% to 4% (school attendance), 35.1% to 11%

Table 1.1: Macroeconomic and Social Indicators

	2019	2020	2021	2022	2023(e)	2024(p)	2025(p)
Real GDP growth	2.0	2.6	1.9	0.1	0.5	1.2	2.1
Inflation	7.8	9.9	8.1	17.9	21.3	16.1	7.2
Overall fiscal balance, including grants (% GDP)	-2.6	-4.9	-6.0	-6.2	-4.2	-3.3	-2.9
Primary balance (% GDP)	-1.9	-4.6	-5.8	-5.6	-3.5	-2.7	-2.4
Current Account (% GDP)	-19.5	-12.1	-19.0	-14.5	-13.8	-11.4	-9.0
GDP per capita (USD)	2077	2175	2369	2409	3358	4034	4462
Total population (million)	0.21	0.22	0.22	0.23	0.23	0.24	0.24
Life expectancy at birth (years)	68.523	67.785	67.591	68.794	68.887	68.984	69.077

Source: Data from Domestic authorities; estimates (e) and projection (p) based on authors' calculations. AfDB Statistics Department, April 2024

(sanitation), 29.3% to 7% (electricity) and 1.3% to 0.3% (housing access). STP scored 0.618 on the 2021/2022 Human Development Index (HDI) and 0.609 in 2019, ranked 138 out of 191, placing it as a low-medium human development country. Nonetheless, according to the UN HDR 2021/2022, STP's national poverty line stood at 66.7% and the purchasing power parity (PPP) was 35.6% of the population living below the income poverty line of USD 1.90 a day, compared to a poverty line of 66.2% and PPP of 32.3% in the 2019 UN HDR, a slight increase from the income poverty line. STP made progress in increasing primary school enrolment, which reached 107% in 2017, slightly above the world average of 103.4% across 147 countries. The literacy rate also improved to 90.1% in 2022. Although the share of public spending on education keeps increasing (for instance it increased to 18.6% in the 2023 state budget rose to 18.6% from 17.5% in 2022), the quality and relevance of education remain low, and many students drop out before completing secondary education (lower secondary education completion rate stands at 60%)[2]. As a result, large segments of the population are unskilled. The national unemployment rate rose to 15.7% in 2022 from 8.9% in 2017, with women (14.6%) and youth in the 15-24-year age group (21.3%) being the most affected.

1.4 Macroeconomic Outlook and Risks

STP's real GDP growth will improve slightly over the next two years to1.2 percent in 2024 and 2.1 percent in 2025. This improvement will be driven by an increase in construction activity, mainly due to higher external funding for infrastructure development projects, and a continued recovery in the tourism sector, which will have positive spillover effects on other sectors of the economy. However, the outlook is subject to significant risks, such as delays in the implementation of key reforms, especially the reform of the energy sector, which could reduce the fiscal space for social and infrastructure spending. Other challenges include high fiscal deficits caused by the bailouts of state-owned enterprises (SOEs) and wage bill overruns, as well as external shocks such as volatile international commodity prices, tighter global financial conditions due to rising inflation in advanced economies, worsened by Russia's invasion of Ukraine. Moreover, rising inflation in STP could increase the public debt burden and

Box 1: Impact of tighter international financial conditions (transmission channels)

The country relies heavily on Official Development Assistance (ODA), consisting of both grants and concessional loans, to finance its budget, which accounted for 41.1 percent of total revenue (or 12.1 percent of GDP) on average between 2000-2022. Non-tax revenues were low, amounting to 8.6 percent of total revenue (or 2.3 percent of GDP) on average during the same period. Moreover, the fiscal situation of STP has worsened due to the decline in grant inflows over the years. Grant inflows as a percentage of GDP fell from an average of 30.7 percent in 2000-2009 to 11 percent in 2015-2019, before rising slightly to 16 percent in 2020-2022. The COVID-19 pandemic external financing has been a major factor in the recent increase in grant inflows. This financing is aimed at supporting the health and economic response to the pandemic and mitigate its social impact. The grant inflows have helped to ease the fiscal and balance of payments pressures caused by the pandemic. To reduce the external vulnerabilities and improve the fiscal position, the Government should enhance revenue collection by reforming tax policy and administration, expanding the tax base, and minimizing tax exemptions. These measures are essential to support the economic recovery and address the fiscal challenges.

Moreover, on average, the climate finance annual flow stands at USD 49 million per year. About 99.2% of this annual flow comes from international donors for the public sector while only 0.8% comes from the private sector. Aid inflow accounts for 40% of the total fiscal revenue on average. For instance, during the COVID-19 pandemic, the country managed to mobilize a high level of aid, contributing to a better economic performance in 2020 of 3.1% of GDP against 2.2% in 2021. There is high correlation between the level of aid inflow and economic performance. Therefore, efforts must be made to mobilize more climate finance for the private sector to bridge the country’s climate financing gap. Although the initial cost of meeting the country’s NDC by 2030 stands at USD 150 million, the country’s overall financing gap for the entire climate plan is USD 60.1 million.

The country will need to invest heavily to transform its power sector from thermal to green generation. Today, 18.35 MW (or 92.4%) and 1.50 MW (or 7.6%) of power generation is thermal and hydro, respectively. The local production capacity totals 19.85 MW for a demand of 20.8 MW. According to the World Bank, the country’s power demand is projected to reach 51.7 MW in 2035 and therefore, the country will need to invest around USD 223.3 million to meet its power demand and transition to green energy. This will require the share of renewable energy in the installed capacity energy to reach around 50%. A mix of green power generation must be considered such as solar energy, natural gas and hydropower to replace the current thermal plants which today consume large amounts of fuel oil. Water and sanitation access in rural areas in STP stands at 75% and 26%, respectively, and will require an investment of USD 144.3 million for 2017-2030 to reach the SDG targets for access. However, almost no investments have been made in these sectors and the level of investment required remains the same as in the country’s original water strategy. The blue economy is another investment target, where the island state should invest heavily to take advantage of its environmental endowments. According to the country’s Blue Economy Strategy (BES), around USD 116.1 million is needed for the environment (climate change, coastal area, biodiversity), fisheries, tourism, water and spacial planning.

Therefore, it is critical for countries in Africa to have greater and better access to international finance to bridge the infrastructure financing gap across and STP is not an exemption. Sao Tome and Principe need for cheap and affordable international finance is key for country’s transformation and development.

force the authorities to tighten monetary policy and focus on fiscal consolidation, hampering the economic recovery. In addition, climate shocks could pose a threat to the country's agricultural and fisheries sectors. These risks underscore the need for STP to implement reforms to put the country on a sustainable and resilient path. The country needs to diversify its economy and improve its business environment to attract more private investments in order to create more jobs for young people.

The fiscal deficit is expected to decline slightly to 3.3 percent and 2.9 percent of GDP in 2024 and 2025. The Government plans to continue fiscal consolidation policies aimed at improving the macroeconomic prospect of the country and boost business confidence. It aims to achieve a gradual fiscal adjustment by increasing revenues, reducing public expenditure, and improving the efficiency and quality of public services. Specifically, on the revenue side, these efforts will include the consolidation of the VAT system and process to increase revenue collection as the economy recovers. On the expenditure side, the Government is working to enhance oversight of capital spending projects and to streamline expenditure. To widen the tax base, reforms to stimulate private sector investment are crucial for the future. However, the continued social pressure resulting from tax burden borne by the population has created hostility towards the government policies to expand the tax base. Trade unions are requesting higher wages to maintain employees purchasing power due to high levels of inflation and tax increases such as the introduction of the VAT in June 2023. This calls for the Government to implement policies that will stabilize exchange and inflation rates.

STP's economy suffers from a limited production base that hinders economic diversification and reduces the country's resilience to economic and climate shocks.'

Risks: The power sector dependency on fossil fuel is likely to continue over the next few years due to the investment needed to transform the sector. Moreover, the poor business environment, especially the unreliable energy supply, and the lack of investment in key economic infrastructures are hampering growth in the medium term. Another obstacle to economic activity is the government's arrears to domestic and foreign companies. The country's growth prospects are also threatened by geopolitical risks arising from Russia's invasion of Ukraine and the escalation of the conflict in the Middle East. Moreover, the recent population data indicate that since the end of COVID-19 and following a relaxation of visa requirements to Community of Portuguese Language Countries (CPLP), over 50,000 people (almost a quarter of the population) have emigrated, worsening the country's skills shortages. These risks can have a major impact to the country's economic growth prospects. The country's current growth is insufficient to meet the employment needs of the youth population, so the economy needs to achieve double-digit growth to absorb the current level of employment demand.

The Debt Sustainability Analysis (DSA) by the IMF and World Bank, conducted in September 2022 notes that STP's public debt is sustainable but still in distress.[1] The main reason for this was the unresolved external arrears after the HIPC initiative (to Angola, Brazil, and Equatorial Guinea). Some debt indicators had surpassed the thresholds under the baseline scenario, but the public debt was projected to decrease over time with fiscal consolidation, energy sector reforms, and prudent external borrowing policies. Downside risks and liquidity pressures remain high. The authorities continue to actively engage with Angola, Brazil, and Equatorial Guinea to regularize outstanding external arrears. Regarding external arrears owed by STP to private creditors, the authorities were making good-faith efforts to reach agreements. Moreover, São Tomé and Príncipe has been identified as fragile country with a number fragility factors, given its small size, geographic isolation, limited resources and developing country status, São Tomé and Príncipe is particularly vulnerable to the adverse effects of overdependence on Official

1 IMF 2022.

Development Assistance (ODA), public debt and reliance on agricultural export. The country is also significantly vulnerable to climate change.

1.5 Policy options to foster high and resilient growth: Supporting macroeconomic stability and economic transformation.

The main objective of the monetary policy of the Central Bank of Sao Tome and Principe (BCSTP) is to achieve price stability and a stable and sound financial system while promoting sustainable economic growth. Monetary policy has been anchored on the peg of the dobra, the national currency, to the euro since 2010.[2] This means that the BCSTP cannot pursue independent monetary and exchange rate policies. The currency peg has a number of benefits for STP's economy, such as lowering transaction costs, maintaining price stability and enhancing monetary and fiscal discipline. However, it also has some drawbacks, such as restricting the BCSTP's ability to influence demand and cushion the impact of external shocks on the economy and affecting the economy's regional and global competitiveness.

Monetary policy, which was largely accommodative to support economic activity until the outbreak of the COVID-10 pandemic, has been gradually tightening amid higher inflation risks. The authorities ought to continue implementing restrictive monetary policy to contain inflationary pressures to an acceptable level. The BCSTP should also continue to implement policies which contain inflation in order to increase private sector confidence in the economy.

STP's fiscal deficit has been persistent as government spending has exceeded tax revenues. To address its fiscal challenges, STP needs to improve its revenue collection, rationalize its public spending, and enhance its fiscal management and transparency. To overcome the persistent deficits, the country should implement policies that strengthen its public finance management (PFM), procurement and governance policies. Further to these measures, STP should be able to access ease and cheap finance from international markets without paying a premium for its perceptions. Small economies such as the STP are ill-treated by large investors and donors due to distorted perceptions of the country. Therefore, STP should call for urgent Global Financial Architecture (GFA) reforms to allow the country access cheap financing to transform its economy. Most smalls economies such STP tries not to default and tries always to honour their obligations with all donors and investors.

Total revenue (including grants) collection in STP has underperformed in recent years, averaging 22.3 percent of GDP between 2020 and 2022. This is a major decline from the peak of 39.5 percent of GDP in 2011. This is attributed to a shrinking tax base due to lower income and profits following the economic slowdown caused by the COVID-19 pandemic and power outages. It is also attributed to unresolved arrears between the Government and the state-owned water and electricity company (Empresa de Água e Eletricidade - EMAE)[3] and the fuel importer (Empresa Nacional de Combustíveis e Óleos, SARL - ENCO)[4], which affected fuel tax revenues, as well as delays in implementing tax and customs reforms. To reduce the external vulnerabilities and improve the fiscal position, the Government should enhance revenue collection by reforming tax policy and administration, broadening the tax base, and minimizing tax exemptions. These measures are essential to support economic recovery and address the fiscal challenges.

2 The Dobra was pegged to the Euro in 2010 at a stable rate of 1 Euro = 24.500 STD.
3 EMAE is a state-owned monopoly that manages water and electricity in STP. It was established in 1998 as a result of the merger of two public companies: EMA (Water Company) and ENE (National Electricity Company).
4 ENCO is partly owned by Sonangol, the Angolan state-owned oil company, and partly by the GoSTP. It was established by government decree in 1998 and is mainly involved in the import and trading of petroleum products. It operates in the downstream sector of the oil and gas value chain, with a focus on distribution, logistics and marketing.

2

TAKING STOCK OF THE COUNTRY'S STRUCTURAL TRANSFORMATION PROGRESS

KEY MESSAGES

- **STP's economy has undergone some structural changes since 1990, but it has not diversified enough into manufacturing and other high-value sectors**.

- **STP remains largely dependent on low-skilled and low-productivity economic activities, especially in agriculture.** Most of the population is engaged in low-skilled self-employment and informal activities, failing to create quality jobs that could alleviate poverty.

- **STP needs to scale up human development investments to build the human capital needed to drive the country's development agenda.**

- **STP's Vision 2030 seeks to turn the country into a regional leader in maritime, financial, and tourism sectors, by investing in infrastructure, agriculture and the blue economy.**

- **The Government needs to continue broadening the tax base to improve the domestic revenue collection and prioritize prudent public finance management**. The required tax-to-GDP ratio required to close the estimated annual financing gap in STP is 2% by 2030 and 0.36% by 2063.

- **STP needs about 14 percent of GDP in additional annual investment to achieve the human capital and infrastructure development by 2063**.

2.1. Introduction

This chapter aims to provide a comprehensive overview of Sao Tome and Principe's recent progress in economic transformation in a changing world, to identify its key trends and outline its characteristics, and to assess the financing needs to fast-track structural transformation. It will take both a historical perspective (what has been done so far) and a forward-looking approach (what can or should be done in the future to accelerate progress) on structural transformation, comparing to Sao Tome and Principe's performance with that of Africa and other peer countries and drawing lessons for the future. The chapter will assess the impact of a wide array of socioeconomic, financial, governance and external factors on Sao Tome and Principe's structural transformation (or lack thereof), as well the financing needs and financing gap, with the objective of highlighting the main pull and push factors and guiding both evidence-based policymaking and investment opportunities.

2.2 Taking stock of economic performance and transformation in Sao Tome and Principe

Following independence from Portugal in 1975, the Government of São Tomé and Príncipe (GoSTP) adopted a socialist system of government, based on public ownership of the means of production, as opposed to private ownership. The GoSTP's development plan aimed to nationalize the plantations that were previously owned by the Portuguese and use the agricultural revenues to invest in other economic sectors. However, this plan failed as agricultural productivity and output declined significantly, due to lack of investment, loss of technical expertise as Portuguese managers left the country, and mismanagement. As a result, STP's economy shrank, with no structural transformation for the next decade. At independence, the economy was based on a cocoa monoculture, run by state farms after the Roças nationalizations of September 30, 1975.[5] Cocoa production fell from 10,400 tonnes s in 1974 to 3,378 tons in 1984, combined with low farm wages that led to massive rural-urban migration, resulting in high income inequality and poverty.

In the late 1980s, the Government decided to transition to a market economy by allowing more room for the private sector to operate. It privatized agriculture and distributed two-thirds of the former plantation land to over 10,000 families on a temporary basis. The goal was to create an agricultural sector that consisted of small and medium-size farms.[6] The recession in STP was overcome by a boost in agricultural output, which stimulated the growth of real gross domestic product (GDP) by 1.3 percent annually from 1990 to 1999 and by 4.2 percent annually from 2000 to 2009. However, these growth rates were still below the African average, which was 3.3 percent and 4.7 percent for the same periods (Figure 2.1)

Another factor that contributed to growth was the commencement of inflows of Official Development Assistance (ODA) into the country, which were used for social and public investment programs. However, STP economic growth was also not sufficient to translate into meaningful change in GDP per capita given the population growth, which averaged negative 0.6 percent and 1.8 percent during 1990-1999 and 2000-2009, respectively, lower than the continental average of 0.8 percent and 1.8 percent (Figure 2.2).

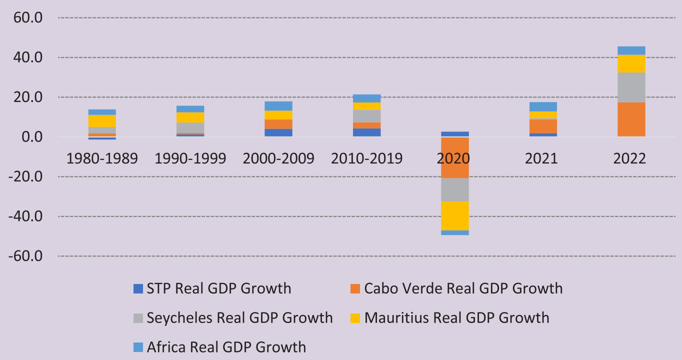
2.3 Sao Tome and Principe's structural transformation: Drivers, bottlenecks, opportunities

(a) Sao Tome and Principe's structural/economic transformation

STP's economy has experienced a number of structural changes since 1990, but it has not diversified enough into manufacturing and

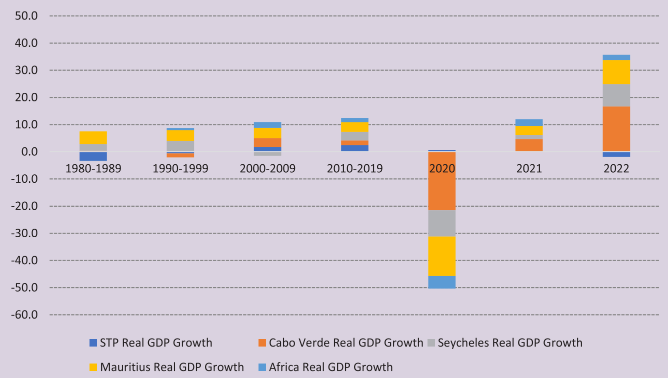
5 World Bank 2005.
6 World Bank 2019a.

Figure 2.1: STP Real GDP growth versus Africa and peer countries



Source: Data from Domestic authorities; estimates (e) and pre (p) based on authors' calculations. AfDB Statistics Department, April 2024

Figure 2.2: STP Real GDP per capita growth versus Africa and peer countries



Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024

other high-value sectors. The economy's structure has shifted slightly towards the primary and tertiary sectors, while the secondary sector has declined. STP continues to be reliant on low-productivity activities in the primary sector. The primary sector, which includes agriculture, forestry and fisheries, accounted for about 11.6 percent of the economy on average from 2000 to 2009, but this share rose to 12.2 percent in 2015-2019, and to 14.6 percent in 2020-2022, on average. Although the primary sector has become more varied, with palm oil as a new cash crop, crop farming and fisheries have not made much progress. The share of workers in agriculture has increased marginally in the last two decades, from 18.3 percent in 2000-2009, to 19 percent in 2010-2019, and to 20 percent in 2020-2021.[7] This implies that the 20 percent of workers in agriculture accounted for only about 14.5 percent of the national GDP, on average, in 2020-2021, reflecting the sector's low productivity.[8]

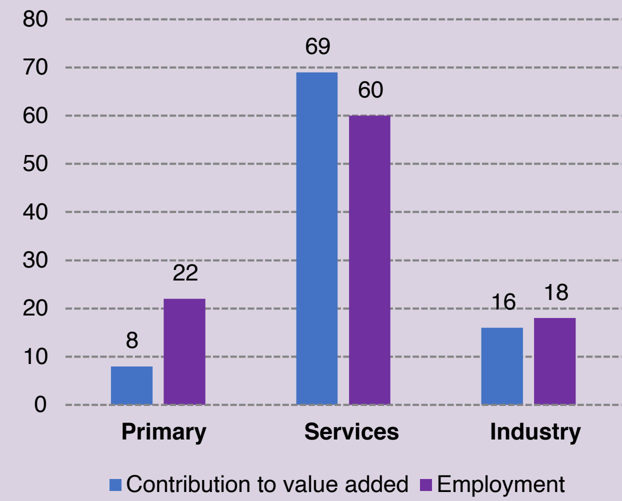
The secondary sector, which includes manufacturing and other industries, has seen a sharp drop in its economic contribution over the past two decades. The sector's share of GDP went down from an average of 17.2 percent in 2000-2009 to 16.7 percent in 2015-2019 and then to 13.2 percent in 2020-2022, mainly because of the weak performance of manufacturing. Manufacturing's share of GDP decreased from 8.3 percent in 2000-2009 to 7.5 percent in 2010-2019 and then to 5.8 percent in 2021-2022, showing the inability of STP to expand its production and export diversity. Manufacturing, which often employs low-skilled workers who leave traditional agriculture, has remained underdeveloped. It has lost competitiveness in the global market due to the specific challenges faced by this small island developing state, such as the small size of its domestic and labour markets, its remoteness from large markets and its exposure to climate change.

The economy has relied mainly on the tertiary sector, which maintained a stable average share of GDP at around 71.2 percent from 2000 to 2009 and from 2010 to 2019, before increasing to 72.2 percent from 2020 to 2022. The main contributors to tertiary sector growth were finance, insurance, real estate & business activities, and wholesale & retail trade, restaurants and hotel services.

(b) Unpacking Sao Tome and Principe's structural transformation through labour productivity decomposition

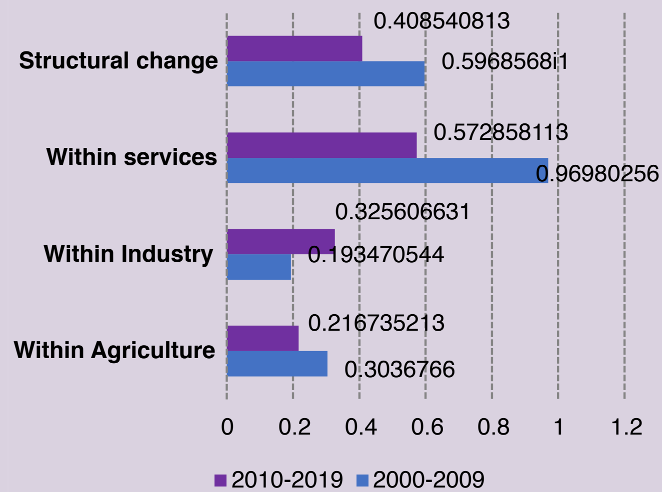
7 Most recent employment figures only available up to 2021.
8 World Bank 2019.

Figure 2.3: Sectoral Employment Shares in STP, 2008-2019



Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024

Figure 2.4: Aggregate Labour Productivity Growth: contribution from within and structural change, income groups, 2000-2009



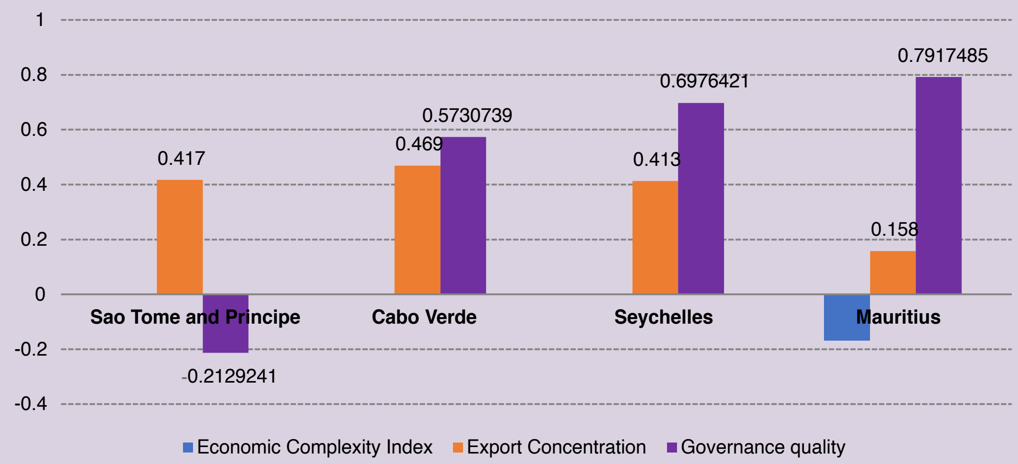
Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024

The employment rate in the period 2008-2019 stood at 22%, 60% and 18% for primary, secondary and industry sectors, respectively (Figure 2.4). It is clear that the services sector has contributed the most to employment in terms of its share to the GDP. It is also the largest contributor to the value added (69%), followed by industry (16%) and the primary sector (8%). At the same time, labour productivity has been higher in the services sector for both the 2000-2009 and 2010-2019 periods, standing at 0.96 and 0.57 (Figure 2.3). Agriculture was overtaken by industry. In the period 2000-2009 the agricultural sector had a higher productivity of 0.30. compared to 0.19 for the industrial sector but in the period 2010-2019 the industry sector had a productivity of 0.32 higher than the 0.22 for the agricultural sector. The industrial sector has become more productive than the agricultural sector over the years, and the overall structural change of the country has shifted from 0.40 to 0.60.

According to the International Labour Organization (ILO), the unemployment rate was 15.3 percent in 2022, down from 15.9 percent in 2021.[9] The unemployment rate is especially high for women (21.9 percent) and youth (22.7 percent). Many young people migrate to urban areas in search of better opportunities but find few decent jobs. As a result, the rural areas are underpopulated and the agricultural sector is underdeveloped, despite its potential to boost the economy. One of the reasons for the high unemployment rate is the mismatch between the skills of the labour force and the demands of the labour market, exacerbated by low levels of education. People with between 7 and 12 years of education had the highest unemployment rate of all education levels, at 12.7 percent, while those with less than six years of education and post-secondary education had unemployment rates of 5.9 percent and 9.9 percent, respectively. This is more a reflection of the fact that people with a less education do not have the choice of not participating in the labour market and that the highly educated people have easier access to jobs. This suggests that there is a need for more vocational training and lifelong learning opportunities to enhance the employability of workers and reduce skills gaps.

9 ILOSTAT (www.ilo.org).

Figure 2.5: Structural Transformation in STP and Peer Countries, 2021



Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department,

STP is highly dependent on a small number of export products and services, which is the same for all its peers except Mauritius. STP's export concentration in 2021 stood at 0.42, which is more or less the same for Cabo Verde (0.47) and Seychelles (0.41). Mauritius has an export concentration of 0.16, which is lower than the levels for STP and its peers (Figure 2.5). Thus, the country needs to put in place policies to diversify its economy, moving it away from the traditional export products and services.

(c) Rapid growth in income and jobs embodied in services export: New evidence.

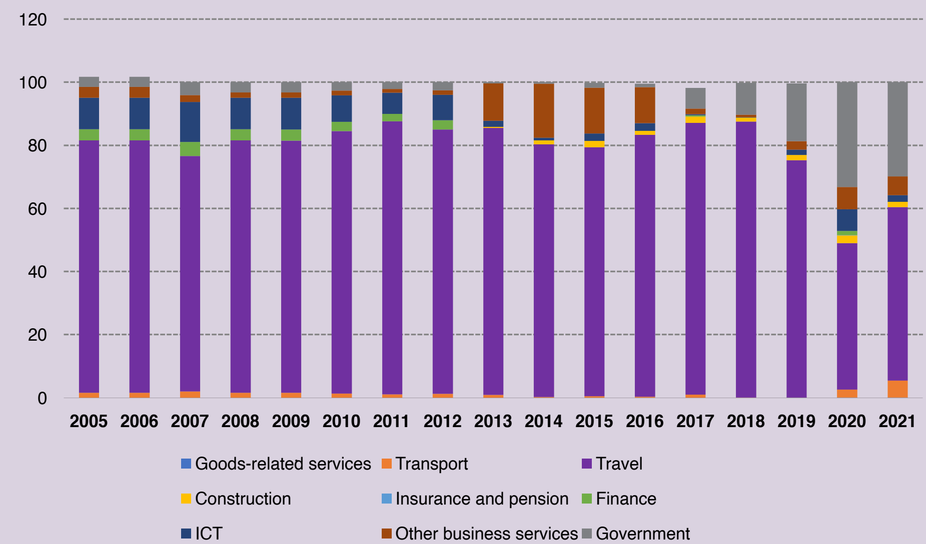
The tourism sector was the largest contributor to exports during the 2005-2021 period, with the exception of the 2020 and 2021 (Figure 2.6) due to the COVID-19 pandemic. This shows the risk of a country being dependent on one main export service. As has been seen above the service sector is also the main source of employment in the country, including the tourism sector, which has a high weight on economic performance and growth. Nonetheless, efforts should be made to diversify the sector with different types of tourism packages and attractions and to make it more efficient.

(d) Drivers to accelerate structural transformation

Agriculture: The GoSTP's strategy aims to transform the agricultural sector into one that generates employment and income, bringing prosperity while respecting the environment. The strategy also proposes to transform smallholder subsistence production into rural entrepreneurial production. Therefore, the strategy calls for competitive agriculture and agro-industry. targeting both the domestic market and regional and international market niches. This transformation will help to strengthen food security and nutrition of the population, improve family incomes and enhance the country's export capacity.

Agriculture is a vital sector for Sao Tome and Principe, accounting for 13 percent of the GDP and 80 percent of the export earnings. Most of the farmers are smallholders who rely on traditional methods and occupy 44,000 ha of the scarce arable land of 96,000 ha in STP. The rest is mostly covered by forests. Cocoa is the main crop, covering 26,076 ha of land and generating more than half of the export revenue in 2021

Figure 2.6: Sector distribution of services in STP, 2005-2021



Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024

with an annual output of 3,000 tonnes that are mainly exported. Palm oil is another key export crop, contributing over 30 percent of the export revenues in 2020 and ranking second after cocoa. Other export crops include coffee, pepper, and coconut. Supporting the small-scale farmers who make up the bulk of the agricultural sector in this country is essential to transforming the sector and creating more employment opportunities, reducing social disparities and eradicating poverty. STP has seen the emergence of new processing industries in the agro-industrialization of cocoa, pepper and coconut oil, which offer potential for development in the coming years. For example, chocolate produced by two local companies is exported to international markets such as the United States and France. A new chocolate factory financed by the AfDB and run by a cooperative was expected to be completed and start exporting organic cocoa in 2023. Moreover, the country produces and used to sell tropical flowers to Europe, though in small amounts. However, coffee production has a low export value and is not very significant. The fisheries sector also provides livelihoods for about 30,000 people (15 percent of the labour force) in STP. This includes about 4,155 fishermen who operate small-scale fishing vessels, as well as many others who work along the value chain.

Energy sector. A key obstacle to STP's economic growth is the scarcity and high cost of energy sources, stemming from heavy dependence on imported fossil fuels. According to the World Bank, imported diesel fuels 92 percent of STP's electricity generation in thermal power plants. This exposes the country to the risks of oil price and supply shocks, and contributes to its greenhouse gas (GHG) emissions. In addition, the current energy system suffers from low electrification rate, inadequate capacity, high electricity production cost, and frequent disruptions. STP has also experienced frequent power outages since 2018. These factors raise operating costs and lower the competitiveness of businesses in various sectors, hindering private sector and SME development (including agro-processing due to lack of cold storage), tourism and related services, and the ICT sector. The lack of reliable and affordable electricity also hinders public service delivery, especially in education and health sectors. Thus, enhancing the energy supply is vital for improving the productivity and profitability of the country's enterprises. Only 2.4 MW of the country's generation capacity comes from hydroelectric sources. The country's total installed capacity is 34.8 MW, with 32 MW in São Tomé and 2.88 MW in Príncipe. However, only about 60 percent of this capacity is available, due to poor maintenance and frequent breakdowns. Peak demand is estimated at 50 to 55 MW, which exceeds the available supply. Tariffs are also not cost-reflective, although the cost of producing electricity is high, ranging from USD 8.3 to USD 49.3 per kWh.

Industrialization: STP is one of the least industrialized economies in Africa, ranking 44th out of 52 countries in the Africa Industrialisation Index 2022. This low level of industrial development is undoubtedly related to the specific challenges faced by this small island developing state, including the size of its domestic market and workforce, its remoteness from large markets and its vulnerability to climate change, all of which hamper economic diversification away from agriculture. These structural obstacles render the country's pathway to industrialization challenging, but they do not prevent Sao Tome and Principe from achieving structural transformation and the associated levels of development, as demonstrated by peer African island states such as Cape Verde, the Seychelles, and Mauritius. This, however, requires the country to find a new path, considering its potential and comparative advantages, as well as market trends. Instead of conventional industrialisation with a focus on manufacturing, Sao Tome and Principe has alternative growth solutions at hand, already captured in the national policies, through the development of improved agriculture, tourism, and blue economy sector, with emphasis on green growth, value addition and ecological protection.

Trade policy: STP is part of several regional organizations that aim to foster economic and political cooperation among African countries. It is a member of the African Union; the Economic Community of Central African States (ECCAS), a regional bloc that seeks to integrate the economies and policies of 11 Central African countries; and the Community of African Portuguese- Speaking Countries (PALOP), a cultural and linguistic group that comprises six African countries that have Portuguese as their official language. The country has a special status within the Economic and Monetary Community of Central Africa (CEMAC), as an observer member. It has expressed interest in becoming a full member of CEMAC in the future, which would entail adopting the common currency (the CFA franc) and harmonizing its economic policies with the other member states. STP has also signed and ratified the African Continental Free Trade Agreement (AfCFTA), a landmark trade deal that aims to create a single market for goods and services across Africa. The AfCFTA offers STP access to a larger market and the opportunity to diversify its trade with other African countries.

Urbanization: STP has an urban population (2018) of 72.8% and an urban growth rate (2015-2020) of 3.33%, however, a large proportion of the population lives in non-formal settlements with inadequate public infrastructure. The concentration of the population in urban areas exacerbates environmental degradation as the demands on sanitation and constructions concentrated in the cities are high, while the capacity to provide appropriate environmental conditions are not available. The growth of the urban population has not been matched with sufficient advances in social service delivery. In urban areas, poor air and water quality, inadequate water availability, waste disposal problems, and high energy consumption are exacerbated by the increasing population density and the demands of the urban environment. Despite its high population growth rate, the country is unable to capitalise on its demographic dividend through investment in education and technical vocational training.

Information, communication and technology: The telecommunications sector in STP is dominated by two operators, CST, 49% of which is owned by the state and 51% by Visabeira, a Portuguese conglomerate, and Unitel, an Angolan telecommunications company. There are 146,000 mobile lines in the country, representing a mobile population coverage of 86%. This offers a great potential to accelerate financial inclusion via mobile money services. However, the ICT sector faces challenges such as obsolete infrastructure, high costs and limited access to broadband internet services. STP national broadcaster (TVS) is yet to fully migrate to digital technology. The ICT legal and institutional framework does not promote digital start-ups and innovation. Investing in ICT is crucial to reduce telecommunication costs and enable business innovation.

Governance: STP has made progress in public financial management (PFM), but there are still challenges that continue to limit the government's ability to appropriately manage and account for public resources. STP's PFM system still suffers from weak internal oversight, weak institutional capacity and inadequate information technology (IT) systems. Aggregate fiscal discipline is limited due to internal oversight weaknesses in budget execution, and there is limited central government control over the revenue and expenditure of extrabudgetary entities. The low revenue base has led to the accumulation of significant domestic arrears, particularly with the Water and Electricity Company (EMAE). The government's internal and external audit functions are relatively weak, resulting in ineffectiveness in ensuring fiscal discipline.

Business environment, labour market flexibility: STP scored 61.5 on the 2023 Heritage Foundation Index of Economic Freedom,[10] making its economy the 74th freest in the world out of 176 countries and fourth out of 47 countries in the SSA region (only below Mauritius, Cabo Verde and Botswana).[11] The country's overall score is above the world and SSA regional averages. STP's ranking and scores have increased remarkably from 124th and 55.4 in 2017, respectively. According to the Heritage Foundation, although the overall regulatory efficiency has not improved significantly, the procedures for starting a business and obtaining licenses have been streamlined. The country also scored above the world averages in judiciary effectiveness and government integrity, indicating a high level of respect for the rule of law. However, the protection of property rights is still weak, as shown by the low score in this area. The informal labour sector also is still largely weak due to the absence of a well-functioning labour market. The business environment is key to attracting private sector investment and the country should prioritize policies to improve the business environment to support investments in key sectors.

Human capital development: STP faces challenges in the areas of education, skills, and employment. According to the 2021/2022 UN HDR, the country ranked 119th out of 166 countries with a score of 62.7 out of 100. STP had made progress in increasing primary school enrolment, which reached 107% in 2017, slightly above the world average of 103.4% among 147 countries. The literacy rate also improved to 90.1% in 2022. Although the share of public spending on education continues to increase, rising from 17.5% of the national budget in 2022 to 18.6% in 2023, the quality and relevance of education remain low, and many students drop out before completing secondary education. As a result, large segments of the population are unskilled. The national unemployment rate rose to 15.7% in 2022 from 8.9% in 2017, with women (14.6%) and young people aged 15-24 (21.3%) being the most severely affected. Technical Vocational Education and Training (TVET) could be a potential solution to enhance youth employability and productivity, especially in the agricultural, tourism, and renewable energy sectors. However, some 50,000 people have emigrated, exacerbating the country's skills shortage, with the education, health, and construction sectors bearing the brunt. Education and TVET are critical to developing the

10 The Index of Economic Freedom takes a comprehensive view of economic freedom. Some of the aspects of economic freedom that are evaluated (for example, the extent of an economy's openness to global investment or trade) are concerned with a country's interactions with the rest of the world. Most, however, focus on policies within a country, assessing the liberty of individuals to use their labor or finances without undue restraint and government interference.

11 www.heritage.org/index .

Box 2: Potential in agriculture and agribusiness

The agricultural sector plays an important role in the economy, contributing about 13.4% of the GDP and 23% of total export earnings in 2022. It accounts for 18% of the country's employment. However, its contribution to the economy has been declining since independence due to massive emigration of agricultural experts and entrepreneurs. Despite STP's favourable climatic conditions and fertile soils, the sector faces several challenges such as limited land; lack of technological know-how; outdated production techniques; scarcity of land and agricultural experts; insufficient support infrastructure such as storage, transport, and roads; limited access to financing services; shortages of inputs such as fertilizers, machinery, irrigation systems and greenhouse solutions. The sector is also vulnerable to the effects of climate change such as floods and droughts. Currently, agricultural production is mainly focused on export cash crops. Cocoa was the main source of export earnings until 2020, with an average production of 3,000 tonnes per year. The cocoa value chain represents a partial success story, with four commercially viable enterprises currently processing raw cocoa into chocolate, but it remains vulnerable to energy disruptions and high export costs. Palm oil is emerging as the new main export product. It accounted for 46.9% of the country's goods exports in 2022, on a par with cocoa export at 46.3%. Meanwhile, the value of food imports rose from USD 25.7 million in 2018 to USD 31.4 million in 2022, a 22% increase. Food imports represented 45% of the total goods imports in 2022. The country plans to invest more in local food production to meet domestic demand for fruits, tubers, vegetables and meat. The agricultural sector remains vital to the country's food security, foreign exchange earnings (23%) and employment. STP has a huge potential to develop its agricultural sector by adopting organic certification standards and improving its value chains, thanks to its favourable climate and fertile soils. The government's strategy is to transform the sector into a source of employment, and a driver of economic growth, while preserving the environment. Although the country's size does not allow for large scale agricultural production, the Government aims to produce high quality and cash crops for export, in line with STP's vision of "***100% Organic São Tomé and Príncipe***" while preserving biodiversity under the government's Agenda 2030.

human capital required to leverage the country's transformation. Investing in human capital will yield high returns to the country and fill the gap in the skills needed to produce high quality goods and services in the economy.

(e) Key bottlenecks to fast-paced structural transformation

Demographic challenges: STP is a small territory whose population distribution poses many challenges. The geographical distribution of the population is uneven with the coastal islands having a higher population concentration than the central areas. The country's population is estimated at 223,000 (UNCTAD, 2022), with an average annual growth rate of less than 2%, spread over an area of 960 km^2. It has a young population with a median age of 19.13 to 19.30 years and a life expectancy of 68 years for men and 73 years for women, which is above the sub-Saharan average of 62 years[12]. Most of the population is urban, rising from 65.1% in 2015 to 75% in 2021. Spread over its 960 km^2, the population density of 228 inhabitants per km^2 is one of the highest in Africa. Despite its high population density and

12 World Bank Data (2022)

youthful population, the country has been unable to capitalize on its demographic dividend. The national unemployment rate rose to 15.7% in 2022 from 8.9% in 2017, with women (14.6%) and youth in the 15-24-year age group (21.3%) being the most affected. Technical Vocational Education and Training (TVET) could be a potential solution to enhance the employability and productivity of young people, especially in the agricultural, tourism, and renewable energy sectors.

Climate change: Insularity, prolonged dry seasons, deforestation, and rising sea levels constitute considerable vulnerabilities for the country's development. In the agricultural sector, climate change impacts crops, increases food insecurity and affects the production of agricultural products. The floods in Sao Tome' island in December 2021 caused extended damage estimated at 7% of GDP and affected traders and SMEs already weakened by the COVID-19 pandemic. To address these issues, the Government in June 2017 prepared a Multisectoral Investment Plan to integrate climate change and disaster risk in the management of coastal areas. Furthermore, in its NDC to the Paris Agreement (updated 2021), the country has a committed to reducing its gas emissions by 27% by 2030.

STP's economy has experienced some structural changes since 1990, but it has not diversified enough into manufacturing and other high-value sectors.

Informal sector: The private sector in STP is small and consists mostly of micro, small and medium-sized enterprises (MSMEs), which account for about 90% of the sector. Only about 38% of the 9,602 MSMEs are formally registered. Despite the opening of a one-stop shop for business registration 14 years ago, most MSMEs (62%) operate informally, mainly in the retail sector (70%), which limits their access to finance and business development services. According to the World Bank's 2020 Doing Business (DB) report, the country's business environment remains challenging, ranking 170th out of 190 countries with a score of 45. This is well below the continent's average rank (140) and score (51.8). The country did not improve its ranking and score from the 2019 Doing Business report. Another major issue for the private sector is the frequent power outages, which force them to rely on diesel generators, increasing their operating costs.

Financial constraints: The financial and banking sector in STP is small, underdeveloped and highly concentrated, with few services available. The sector has grown slightly since independence, but it is still dominated by a few banks, which account for about 90 percent of the financial sector assets, and consists of one microfinance institution, one insurance company and one pension fund. Since 2000, the banking sector has been liberalized, allowing new banks to enter the market. There are now four commercial banks that offer investment and deposit services: the International Bank of Sao Tomé and Principe (BISTP), a joint venture between the Government (48 percent) and two foreign banks (Portuguese and Angolan);[13] ECOBANK (Lomé, Togo); Afriland First Bank (Cameroon); and BGFI (Gabon). The BCSTP has also closed down three other commercial banks that became insolvent in the last seven years: the Banco Equator (Angola) in 2016, the Banco Privado de Sao Tome (Cameroon) in 2018, and the Energy Bank (Nigeria) in 2022. The recent collapse of the three banks closed by the BCSTP in STP shortly after receiving their license highlights the shortcomings of the central bank in assessing the applications and authorizations of new banks and in supervising the banking sector effectively.

2.4 – Finance to fast-track Sao Tome and Principe's structural transformation

(a) Identify structural change strategy in the national development plan

The main objective of the Long-Term-Strategy-LTS (Agenda 2030)'s is to achieve rapid economic

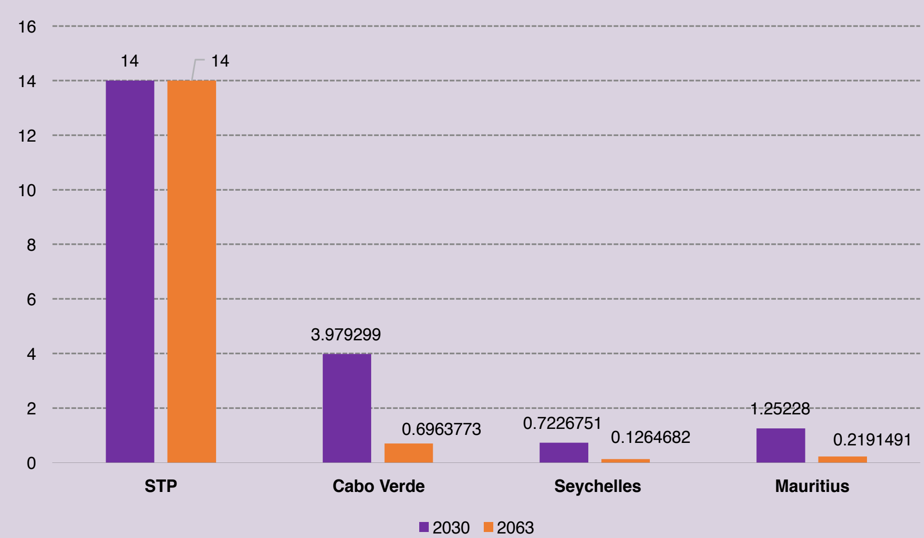
13 Government (48 percent), Caixa Geral de Depósitos in Portugal (27 percent), and Banco Africano de Investimentos in Angola (25 percent).

growth to generate sufficient employment and well-being for the population by reducing poverty and malnutrition. Sector strategies and programmes feed into the Agenda 2030. The LTS covers the 2016-2030 period and is aligned with the Sustainable Development Goals (SDGs). It identified the following development challenges: (i) low productive base and economic diversification; (ii) weak public administration; (iii) lack of infrastructure; and (iv) lack of domestic capital. The projected financing needs for the period 2016-2019 stood at USD 900 million with a focus on the deep-water port (USD 550 million) and other infrastructure projects (USD 350 million), including a new airport. Unfortunately, the implementation rate of the strategy is slow and a mid-term review of the strategy is needed to gauge its progress. Based on the Agenda 2030, the new government's programme (2022-2026) is anchored on four pillars, namely: (i) improving the business environment; (ii) restoring economic and social infrastructure; (iii) improving the performance of public institutions; and (iv) ensuring sustainable and inclusive development. The 2022-2026 Government Programme aims to ensure sustainable and inclusive development of the country. Putting in place a very robust national development strategy and plans are critical for STP transformation. This strategy and policies should be anchored on the country's comparative advantages while ensuring timely implementation of its plans with a good monitoring system. However, the strategy and plans come with high implementation costs and most often STP does not have access to the easy and cheap financing required for the projects anchored in these plans.

(b) Financing needs and financing gap

STP needs about 14 percent of GDP in additional annual investment to achieve the desired human capital and infrastructure development by 2063 (Figure 2.7). Considering the country's investment spending efficiency, the initial capital stock, and the capital depreciation rate, to meet its SDGs by 2030, STP needs additional annual investment of 2.7 percent of GDP in health, 3.5 percent of GDP in education, 1.3 percent of GDP in electricity, 2.0 percent of GDP in water and sanitation, and 4.7 percent of GDP in infrastructure (e.g., roads, airports and ports).5 Therefore, the country will need around USD 2.7

Figure 2.7: Estimated annual financing gap (as per cent of GDP) by STP and peer countries for structural transformation by 2030 and 2063



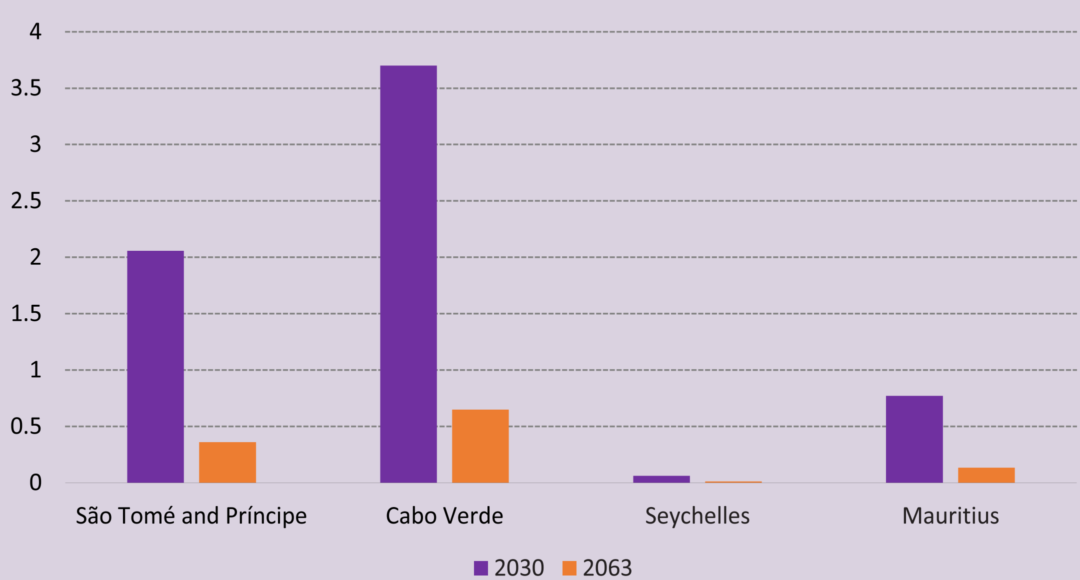
Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024 billion in real terms annually by 2063 to transform the country. These estimates show significantly higher financing needs and gap for STP compared to its peers (Figure 2.7).

(c) Closing the financing gap through domestic resource mobilization

STP faces the challenge of financing its current account deficit. The country relies heavily on official transfers and foreign direct investment (FDI) to finance its current account deficit. Official transfers largely consist of funds that STP receives from other countries or international organizations, mainly in the form of grants and concessional loans. FDI is essentially the investment made by foreign entities in STP's domestic businesses, especially in the oil sector. STP is the only country in the Gulf of Guinea without significant oil production yet. Several oil blocks have been awarded to various international oil companies, but no viable oil block has yet been found. Total, British Petroleum (BP) and Gap have been involved in the oil and gas exploration process. However, the oil exploration process has faced many challenges and delays. For example, Total Energies had to apply for an extension of its exploration license. Nonetheless, in 2019, the Dutch company Shell acquired the rights to five oil blocks from Kosmos and in April 2022 the company started the drilling process of oil field 6 located in the Exclusive Economic Zone (EEZ) with good preliminary results. The recent preliminary results prompted the Brazilian Oil Company (Petrobras) to acquire 45% stakes in blocks 10 and 13 and 25% in block 11 from Shell. Therefore, the medium-term outlook is positive with the first production expected within 10 years. For the country to leverage expected revenues stemming from the oil sector, it needs a sound national development strategy and plans. At the same time, the country will continue to need access to international financing to fund its large investment plans.

However, both official transfers and FDI are subject to high volatility. This exposes STP to external shocks and poses a challenge for its economic stability. For example, official transfers rose from 20.9 percent of GDP in 2000-2004, on average, to 38.5 percent in 2005-2009, but have declined steadily since then, reaching 11 percent in 2015-2019. FDI also followed a similar pattern, increasing from an average of 3.6 percent of GDP in 2000-

Figure 2.8: Increase in the tax-to-GPD ratio required to close the estimated annual financing gap in STP and peer countries



Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024

Box 3: Bank's support for economic transformation in Sao Tome and Principe

As shown above, STP's development challenges have remained largely unchanged since the approval of the CSP 2018-2023 in June 2018. The country's overarching development challenge remains its limited production base, which hinders economic diversification and a more inclusive and higher growth trajectory for sustainable poverty reduction, reducing the country's resilience to economic and climatic shocks and overcoming its insularity. The economy continues to be dominated by low-productivity activities in agriculture, fisheries, and trade, which have limited STP's growth potential. The overarching development challenge is compounded by several underlying development challenges such as weak institutional capacity, low skill levels, poor business environment, inadequate infrastructure, and unsustainable energy sources. The country's remoteness and insularity also result in high trade and production costs with double costs for Principe.

To address STP's development challenges in a lasting and sustainable manner, a possible development path for the country would envisage a first phase of stabilizing the macroeconomic outlook and shifting the energy mix towards financial sustainability; a second phase of structural transformation, scaling up export-oriented, high-value production capacity (sustainable tourism; high-value agriculture and fisheries, etc.), supported by infrastructure that reduces trade costs; and a third phase focusing on high value digital and financial services. The Bank's new CSP 2024-2029, to be implemented in close coordination and consultation with key DPs, will focus on selected components of phases I and II, with an emphasis on energy transition as a priority, while continuing to invest in the development of high-value agriculture and fisheries, and at the same time, paving the way for future investments in maritime connectivity for both islands and the region.

2004 to 22.5 percent in 2005-2009, mainly due to investment in oil exploration, but dropped to 7.2 percent in 2015-2019. Thus, 'current transfers' have been instrumental in financing the current account deficit, but they are not reliable or sustainable sources of revenue for STP.

STP's fiscal deficit has been persistent as its government expenditure has exceeded tax revenue. As a response to the narrow tax base and low revenue, the Government introduced the value added tax (VAT) in June 2023 at standard rate of 15% and 7.5% for the primary food basket. However, the Government needs to continue broadening the tax base to improve the internal revenue collection and prioritize prudence in public finance management. The tax-to-GDP ratio required to close the estimated annual financing gap in STP by 2030 stands at 2% and 0.36% by 2063. Mauritius and Seychelles have a lower ratio, but Cabo Verde has a higher ratio (3.7%) by 2030 and (0.65%) by 2063 (Figure 2.8).

2.5 Concluding remarks and policy recommendations.

Policy recommendations for Sao Tome and Principe would be to accelerate Sao Tome and Principe's structural transformation through the following measures and policies:

(a) The role of the Government in building strong institutions and implementing critical measures leading to a conducive environment for accelerating structural transformation.

Agricultural policies: Agriculture is a key sector for reducing poverty in STP, as it can provide employment opportunities for low-skilled workers who are more likely to be

poor. A multisectoral approach is essential for STP, especially in the areas of agriculture, infrastructure (transport and water) and energy. These sectors have interrelated challenges and opportunities that require coordinated policies and actions. An integrated approach can enhance the efficiency and synergy of the agriculture, infrastructure and energy sectors, which are interrelated. The country should consider reforming these policies to support and engage farmers, especially smallholders, in providing sustainable solutions to climate change problems.

To enhance the climate resilience and adaptation of various sectors, such as agriculture, it is essential to have policies that support the integration of relevant technologies and services. These policies and programmes should consider the different needs and interests of the value chain actors, and the possible synergies or trade-offs that may arise. For instance, improving rural infrastructure may help rural households, but it may also have a greater impact if it targets or includes larger farms. Therefore, rules and systems should be designed to accommodate both large and small actors. Such partnerships can also leverage existing networks and infrastructure, reduce duplication and costs, and improve the efficiency and quality of extension services.

Energy policy: STP's electricity supply shortages have become a major constraint on the country's growth potential. Therefore, one of the main challenges for the country is to ensure that its population and productive sectors have access to reliable and affordable electricity. The current dependence on diesel generators for thermal energy is not only costly but also harmful to the environment. In addition, access to energy is critical to STP's development efforts and to achieving inclusive growth. Since finding alternative and sustainable sources of energy is a priority for the country's economic and social well-being, the following priorities should be considered. STP has potential for solar energy, especially for small scale and medium-scale solar PV projects. The limited concessional financing available to STP should be allocated to projects that ensure a reliable and stable electricity supply.

Industrial policy for services: Although the country's Long-Term Strategy (Agenda 2030) selects the services sector as one of the country's main pillars, the country does not have a well-structured industrial policy for services, so there is an urgent need to design and adopt an industrial policy.

Trade policies: To achieve more sustainable and inclusive growth, STP needs to access regional markets. The country should focus on the following key reforms to make the most of trade integration: (i) eliminating non-tariff barriers and making border and customs management more efficient; (ii) addressing supply constraints to increase production and export capacity; (iii) actively seeking market opportunities in Africa and beyond and developing trade strategies to access these markets; and (iv) identifying areas where STP has or could have a competitive edge in regional and global markets to diversify its economic activities and products, thereby reducing the country's dependence on a few sectors or markets and increasing its resilience to external shocks.

In addition, to boost its integration into regional and global value chains, STP needs to: (i) build digital skills and platforms that allow it to access online markets and services, and to overcome the barriers of distance and scale; (ii) improve transport infrastructure and logistics to reduce the cost and time of moving goods across borders and regions; and (iii) align its policies and standards with those of its trading partners to ease trade flows and compliance with global value chain requirements, including accelerating the country's accession to the WTO. These measures would help Sao Tome and Principe leverage its natural wealth, such as its pristine rainforests and unique biodiversity, which are attractive for nature-based tourism. They would also help the country exploit its potential for high-quality, niche agricultural production, such as cocoa, coffee, and palm oil.

Policy priorities for improving STP's economic governance and public finance management (PFM): The STP's PFM system has six areas for improvement, according to the Bank's 2020 Country Fiduciary Risk Assessment (CFRA): (i) budgeting legal framework; (ii) alignment of expenditures with plans; (iii) timely quarterly budget reporting; (iv) state accounts quality; (v) follow-up procedures for audit findings and transparency in public resource management; and (vi) capacity building of PFM institutions. The GoSTP needs to accelerate the implementation reforms and measures aimed at enhancing the quality of public sector budgeting, addressing the misalignment between the state budget and sector plans/strategies, improving the quality of budget projections, restoring budget credibility, improving fiscal transparency and public access to fiscal reports, reinforcing state enterprise financial oversight, and enhancing the management of public debt and guarantees. Weaknesses in audit coverage and delays in the completion of external audits by the Court of Auditors (*Tribunal de Contas)* also require urgent attention, as does the absence of legislative scrutiny of the financial statements and the external audit reports. Steps need to be taken to build the capacity of the Inspectorate General of Finance (IGF) and the Court of Auditors. The Government needs to address capacity gaps that hinder the production of the quality financial reports needed to improve fiscal transparency and the quality of decision-making.

The GoSTP needs to enhance the quality of public investment programmes and increase revenue collection to reduce the financing gap. The country also needs to incorporate medium-term fiscal framework (MTFF) projections into budget documents. To improve fiscal transparency and governance, the Government needs to fast track the approval and implementation of the new procurement law, which is set to include requirements for collecting and publishing beneficial ownership information. To increase revenue collection, the Government needs to continue working on measures to expand the newly introduced VAT and to improve the tax administration. The Government has to take steps to address structural problems in the public sector, which include the poor performance of state-owned enterprises, especially EMEA, the state-owned power and water company. EMAE suffers from high losses, low revenue collection, and dependence on imported diesel for power generation.

The BCSTP needs to continue to take measures to improve the monetary policy framework to sustain the peg, including through proactive liquidity management. It has to continue to adopt measures to improve its governance and transparency and to strengthen its independence, internal controls, and oversight capacity. These measures include the enactment of the BCSTP Organic Law; the adoption of International Financial Reporting Standards (IFRS) with a view to finalizing data compilation based on the IFRS standards; settling the legacy debts; revising the Financial Institutions Law with IMF assistance to enhance bank regulation and supervise the legal framework; and maintaining the country's membership in the Inter-Governmental Action Group against Money Laundering in West Africa (GIABA) by communicating with the GIABA Secretariat and paying the membership dues on time to avoid being blacklisted by the Financial Action Task Force (FATF).

(b) Role of the private sector in driving structural transformation.

STP needs to revise the Private Sector Development Strategy 2018-2024 recognizing the vital role of the private sector in the economy and outlining key measures to enhance its performance and contribution to development. The country should also look at the possibility of implementing the Public Private Partnerships law and updating the new Notary

Code and a Commercial Register Code to help create a conducive environment for private sector participation in infrastructure and service delivery.

STP has a rich natural resource base that offers many opportunities for private sector investment. The country needs to enhance the business environment, skills, market access and financing for SMEs and thus increase their economic and job-creation potential.

(c) Role of Development Financial Institutions (DFIs) and Multilateral Development Institutions (MDIs) in supporting Sao Tome and Principe's structural transformation.

DFIs and MDIs are among the most important actors of the current global climate finance architecture as they provide an important channel through which international public finance sources can be leveraged to support the cost of meeting the investments needs necessary to transform a country's economic landscape with emphasis on the impacts of the living condition of its people. Their role in supporting economic transformation and the living conditions of the population is threefold. First, they are instrumental in facilitating the shift of (public and private) investments towards economic transformation taking into account the country's investment projects and programmes. In this regard, they facilitate access to capital, help formulate national development strategies focused on economic transformation and infrastructure, and support the national banking and financial sector in leveraging private investments.

Second, in line with their mandate and leveraging their comparative advantage and convening power, DFIs and MDIs also help countries understand and integrate all types of risk into their infrastructure investment decisions and to ensure that appropriate measures are taken to mitigate investment risks. Third, member countries often use their expertise on investment risk issues to reduce investment costs.

Finally, DFIs and MDIs are key actors in supporting innovation in infrastructure and climate finance instruments. They can, for instance, directly finance pilot projects in developing countries to test the feasibility of a proposed innovative financing instrument, assist in leveraging additional sources of financing (international and or domestic) and draw on their global expertise in provide technical assistance, risk-sharing and guarantee schemes or specific grant financing tools. Moreover, thanks to their strong credit ratings and the backing of their shareholder governments, these institutions can raise considerable financial resources from capital markets at lower rates, allowing them to support infrastructure projects on concessional financing terms. International public finance is also channelled indirectly from donors to MDIs and DFIs. These funds are deployed through various instruments, including repayable and non-repayable grants, concessional loan guarantees and equity investments.

3

FINANCING STRUCTURAL TRANSFORMATION IN SAO TOME AND PRINCIPE: THE NEED TO REFORM THE INTERNATIONAL ARCHITECTURE

KEY MESSAGES

- Public investment in STP is financed mainly by multilateral and bilateral donors through grants and loans, representing around 40% of the overall public investment.
- MDIs and DFIs can play a crucial role in private sector financing for STP by mobilizing additional resources to support these critical sectors of the economy.
- STP will need substantial resources to meet its green growth and climate action targets. According to the NDC, the country needs around USD 150 million to reduce greenhouse gas emissions to 27% by 2030.
- The country's overall estimated financing needs are currently estimated at around USD 2.7 billion up to 2063.

3.1. Introduction

The chapter presents the external financing that the country needs to achieve structural transformation while addressing the threat of climate change. It uses the Bank's estimates of financing needs and gaps to accelerate structural transformation (AEO2024) and to finance climate action (AEO22 and 2023) by 2030. Using the Bank's estimates, the chapter assesses the country's capacity to increase the tax-to-GDP ratio to close the financing gap and ensure structural transformation by 2030 and 2063, and stresses the need for reform of the international financial architecture.

3.2 Sao Tome and Principe's Stand on the Need to Reform the International Financial Architecture

Public investment in STP is financed mainly by multilateral and bilateral donors through grants and loans, representing around 40% of the overall public investments. Tax revenues are used to finance recurrent expenditure due to the narrow fiscal base and the heavy weight of the informal sector, which accounts for around 60% of the economy. STP is already working with MDI in various areas, including the social sector. There are also increasing engagement with MDI in the power sector to facilitate foreign direct investments (DFIs) to address the country's energy challenge. According to the country's Nationally Determined Contributions, the main guiding framework for climate change and green growth, the level of investment in STP stands at USD 150 million for a period of 13 years. Over the past decade, the country has received on average USD 5 million per year from multilateral donors. The investment has been mainly in adaptation and mitigation measures. However, the investment has proved insufficient. The country needs substantial investment to transform the power sector from thermal to green generation. Today, the country generates 18.35 MW (or 92.4%) of thermal power and 1.50 MW (or 7.6%) of hydro power, totalling 19.85 MW against a demand of 20.8 MW but according to the World Bank, the country's power demand is projected to reach 51.7 MW in 2035. Therefore, the country needs an investment of around USD 162.95 million to meet its future power demand and transition to green energy with an installed capacity of about 50% renewable energy. A mix of green power generation (such as solar energy, natural gas and hydropower) should replace the current fuel oil-fired thermal power plants.

Water and sanitation access in rural areas in STP stands at 75% and 26%, respectively, requiring an investment of USD 144.3 million over the 2017-2030 period to meet the SDGs. However, little investment has been made in these sectors and the level of need remains the same as in the original water strategy. The blue economy is ripe for investment to take advantage of the country's unique environmental endowments. According to the country's Blue Economy Strategy (BES), STP needs about USD 116.1 million for the environment (climate change, coastal area, biodiversity, etc.), fisheries, tourism, water and spatial planning.

For these investments to happen, **the policies of the international financing architecture need to be changed to facilitate more financing for critical sectors in Sao Tome and Principe**. The country's needs are higher than the current financing, but the current international financing architecture takes into account factors such as the country's risk rating and public debt, which makes it difficult for STP to access more financing.

3.3 Mobilizing Additional Resources for STP's Structural Transformation

As an island nation with unique challenges and great opportunities for industrialisation, STP cannot rely on the conventional model of manufacturing-led growth, but rather needs to explore alternative pathways that suit its context and potential. Additional resources could be raised by fostering private sector investment. However, it is essential to address the key market gaps that hinder the country's competitiveness and growth potential. Some of the main challenges facing the country are a complex regulatory environment, limited access to finance, skills gaps, and poor infrastructure, which affects trade facilitation, especially at the airport and seaport. By addressing these issues, the Government can create more favourable conditions for private investment and innovation, especially in sectors such as tourism and niche agriculture, where the country has a natural comparative advantage. The MDI and DFIs can support STP in this endeavour by: improving the quality of production factors such as energy and infrastructure, strengthening human capital and skills development, especially vocational training, to foster entrepreneurship, innovation and environmental awareness. These initiatives can help STP diversify its economy, create jobs, and promote social inclusion; support governance and business environment reforms to facilitate private sector development, with a focus on MSMEs. These are the main agents of economic transformation that would contribute to decent job creation, value addition and competitiveness, as well as support institutional development and public-private coordination, with a focus on the implementation of key strategies and policies such as the Private Sector Development Strategy 2018-2024 and the Blue Economy Strategy. The country should develop public-private partnership policies, making use of the recently established PPP legal framework, and support the development of major catalytic investment projects, including in the circular economy and tourism.

3.4 Addressing STP's Debt Situation

The Debt Sustainability Analysis (DSA) carried out by the IMF and the World Bank, September 2022 indicates that STP's public debt is sustainable but still in distress. [14] This is mainly due to unresolved post-HIPC external arrears (to Angola, Brazil, and Equatorial Guinea). A number of debt indicators had exceeded the thresholds under the baseline scenario, but public debt was projected to decrease over time with fiscal consolidation, energy sector reforms, and a prudent external borrowing policy. The general allocation of Special Drawing Rights (SDRs) by the IMF in August 2021 and the final extension of the Debt Service Suspension Initiative (DSSI) until December 2021 provided some temporary relief. The present value (PV) of total public and publicly guaranteed (PPG) debt was projected to return to below the DSA thresholds associated with the country's weak debt-carrying capacity (below 35 percent of GDP) by 2025 after discounting EMAE debt and arrears owed to ENCO. In addition, the liquidity indicators were projected to stay below their threshold values of 10 percent for the debt service-to-exports ratio and 14 percent for the debt service-to-revenue ratio. Moreover, both the PV of the external debt-to-GDP ratio and the PV of the external debt-to-exports ratio were also within their thresholds of 30 percent and 140 percent, respectively. Regarding STP's external arrears owed to private creditors, the authorities were making good-faith efforts to reach agreements. The country needs a more accessible financial market with specific products for small economies such Sao Tome and Principe.

STP has also implemented several reforms to address its debt challenges, such as establishing a debt management unit; approving the legal framework on public debt management; approving a public finance management system; seeking debt relief from bilateral and multilateral creditors; and reforming EMAE to reduce its arrears and losses. Following the expiry of the MTDS in 2020, the MTDS Analytical Tool, a joint product of the World Bank and IMF, is the current debt management framework in STP to guide its debt management decisions and operations. The Government needs to expedite the process of finalizing a new MTDS.

'In order for these investments to take place, the international financing architecture needs to change its policies to facilitate more financing to critical sector in Sao Tome and Principe'

3.5 Climate Action Financing

STP will need more than USD 185.2 million by 2030, or an average of USD 17.8 million per year, to meet its climate change financing needs. According to the country's NDC, the main guiding document for the country's intentions on climate change and green growth, the level of

14 IMF 2022.

investment stands at USD 150 million for a period of 13 years. Over the years, the country has received an average of USD 5 million per year from multilateral donors, mainly for adaptation and mitigation measures.

The country will need to invest heavily to transform the power sector from thermal to green generation. Today, 18.35 MW (or 92.4%) and 1.50 MW (or 7.6%) of power generation is thermal and hydro, respectively. Local generation capacity totals 19.85 MW against a demand of 20.8 MW. According to the World Bank, the country's power demand is projected to reach 51.7 MW in 2035, and therefore the country will need an investment of around USD 223.3 million to meet its power demand and transition to green energy. This will require the share of renewable energy in the installed capacity to reach around 50%. A mix of green power generation such as solar energy and hydropower will need to be considered to replace the thermal plants, which currently consume a large quantities of fuel oil. Rural water and sanitation access in STP stands at 75% and 26%, respectively, and will require an investment of USD 144.3 million for 2017-2030 to reach SDG access targets. However, little investment has been made in these sectors, and the level of investment required remains the same as in the country's original water strategy. The blue economy is another investment target, in which the island state should invest heavily to take advantage of its environmental endowments. According to the country's Blue Economy Strategy (BES), around USD 116.1 million is needed for the environment (climate change, coastal area, biodiversity, etc.), fisheries, tourism, water and spatial planning. The private sector's share of climate finance inflows in STP needs to be revised from the current 99.2% to 60%, with the public sector contributing only 30% of the total climate finance flows by 2035.

STP will need substantial resources to meet its green growth and climate action targets. According to the NDC, the country needs around USD 150 million to reduce gas emissions to 27% by 2030. However, the country's total estimated needs for the 2020-2030 period stand at around USD 185.2 million for mitigation, adaptation and other related activities. National frameworks recognize the private sector can play an important role in catalysing other sources of private sector finance, as well as in directing financing towards sectors that are currently underfunded. The country's green growth and climate policies fully recognized and incorporated the private's sector role. This is expressed in STP's NDC, which identified the need to mobilize resources from multilateral and bilateral donors as well as the private sector to meet the country's financing needs.

The average, annual flow of climate finance is USD 49 million per year. About 99.2% of this annual flow comes from international donors in the public sector. while only 0.8% comes from the private sector. Some non-governmental organizations (NGOs) are heavily involved in climate change awareness and policy advocacy, and most public policies on climate change are implemented by NGOs. On average, aid inflows account for 40% of the total fiscal revenues. For instance, during the COVID-19 pandemic, the country managed to mobilize a high level of aid, which contributed to an improved economic performance of 3.1% of GDP in 2020, compared with 2.2% in 2021. There is a high correlation between the level of aid inflows and economic performance. Therefore, every effort should be made to raise more private sector climate financing to bridge the country's climate financing gap. Although the initial cost to meeting the country's NDC by 2030 is estimated at USD 150 million, the country's total financing gap for the entire climate plan is USD 60.1 million. STP needs to invest in natural capital accounting for the use and conservation of natural resources and incorporate it into the system of national accounts to expand the size of the economy.

3.6 Policy Recommendations

According to the Sao Tome and Principe's Long-Term Strategy (Agenda 2030), the country's projected overall financing needs were around USD 1 billion for major infrastructure such as the deep seaport with an estimated cost of USD 550 million, a clean energy fund of USD 60 million, and a public investment portfolio of USD 305 million. Nonetheless, the presented list is not exhaustive of the country's real needs, which include hydropower plants to ensure a reliable and clean source of energy, roads, seaports, airports, electrification, water and sanitation, and urbanization projects. Therefore, the country's overall estimated financing needs would be around USD 2.7 billion by 2063.

STP would benefit from the acceleration of the scale of concessional lending, the restructuring the GFA to make more transparent and accessible, reforms to facilitate access to emergency financing, the inclusion of small economies countries such as STP in the GFA, the adoption of green policies, and the leveraging of private sector financing for transformation and climate justice. The African Development Bank should be strengthened and capitalized so that it can better meet the continent's investment needs and demands in infrastructure, private sector development and governance.

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ENDNOTES

1 Agreed wording at the African Development Bank Annual Meetings 2022 in Ghana - Algeria, China, Egypt, and South Africa entered a reservation and proposed “Russia-Ukraine Conflict.

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