



GUINEA-BISSAU

SELECTED ISSUES

July 2015

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GUINEA-BISSAU

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Approved By
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THE COSTS OF FRAGILITY IN GUINEA-BISSAU: CHRONIC POLITICAL INSTABILITY¹

Guinea-Bissau is one of the most fragile countries in the world. Behind its fragility condition lays a history of chronic political instability in its most extreme form: recurrent ruptures of the constitutional order through coups d'état. This note aims at identifying some of the main channels of transmission through which political instability feeds and foster fragility, and provide an estimate of the "fragility gap" that haunts the Bissau-Guinean society.

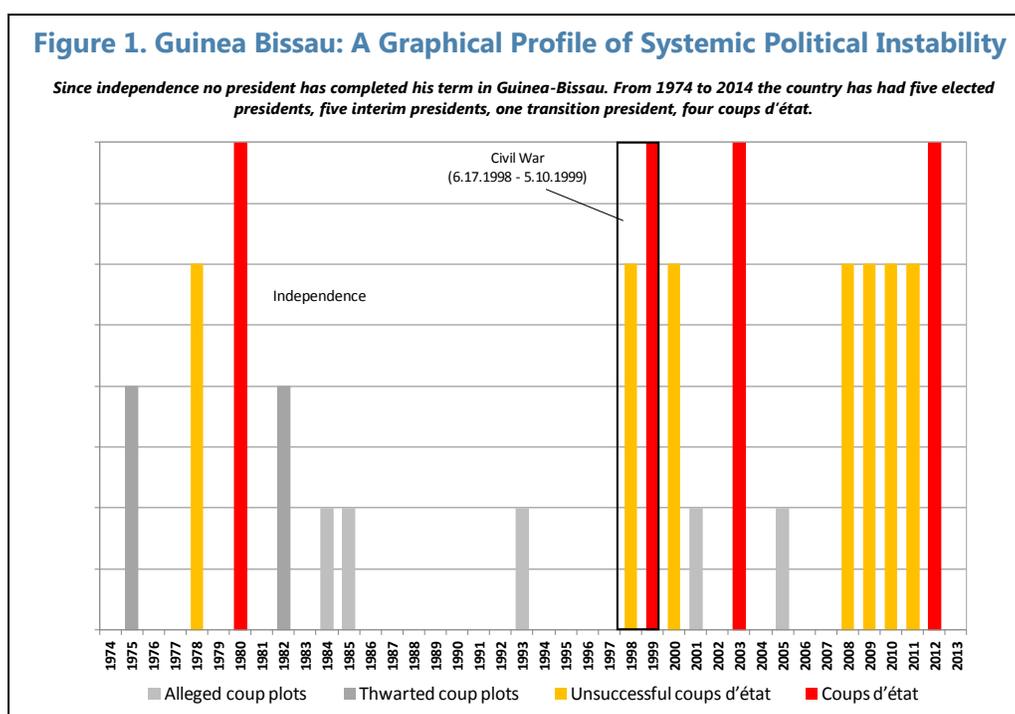
A. Introduction

1. **While experts agree that fragility hinders growth and development prospects, its definition is not straightforward.** Fragility is a difficult-to-define concept, mainly because it has a multidimensional nature. For example, a country *could* be fragile due to its size (e.g. a small island), unprivileged geographical position (e.g. prone to earthquakes or hurricanes), structure of its economy (e.g. low diversification), low educational level of its inhabitants, poor infrastructure and public services, weak institutions, internal conflicts, etc. According to Naudé and McGillivray (2011) the major causes of state fragility are conflict, low development status, vulnerability, and the lack of a developmental state. Moreover, the importance of each factor varies over time for a given country and between countries, and many could be at work at the same time. More importantly, while some factors require a long time to tackle or overcome others, in principle, could have a faster resolution. Despite the multitude of fragility concepts, they all lead to the same conclusion: fragility hinders growth and development prospects
2. **To tackle fragility in Guinea-Bissau it is useful to analyze both, its causes and its costs.** Guinea-Bissau is one of the most fragile countries in the world. As a consequence, it has barely progressed in the last decades, mainly when compared to its peers. In order for a fragile country to overcome this condition, it is crucial not only to identify the main causes behind its fragility but also to assess their costs. The latter can be seen as opportunity cost for a failed security sector reform.
3. **This paper argued that, until today, due to chronic political instability, Guinea-Bissau has been in a costly fragility trap.** This analytical piece argues that the major factor behind Guinea-Bissau's fragility has been the chronic political instability. It also uncovers some of the main transmission channels from political instability to fragility, and provides simple estimates about the cost of instability.

¹ This note was prepared by Tito Nicias Teixeira da Silva Filho.

B. Fragility and Conflict

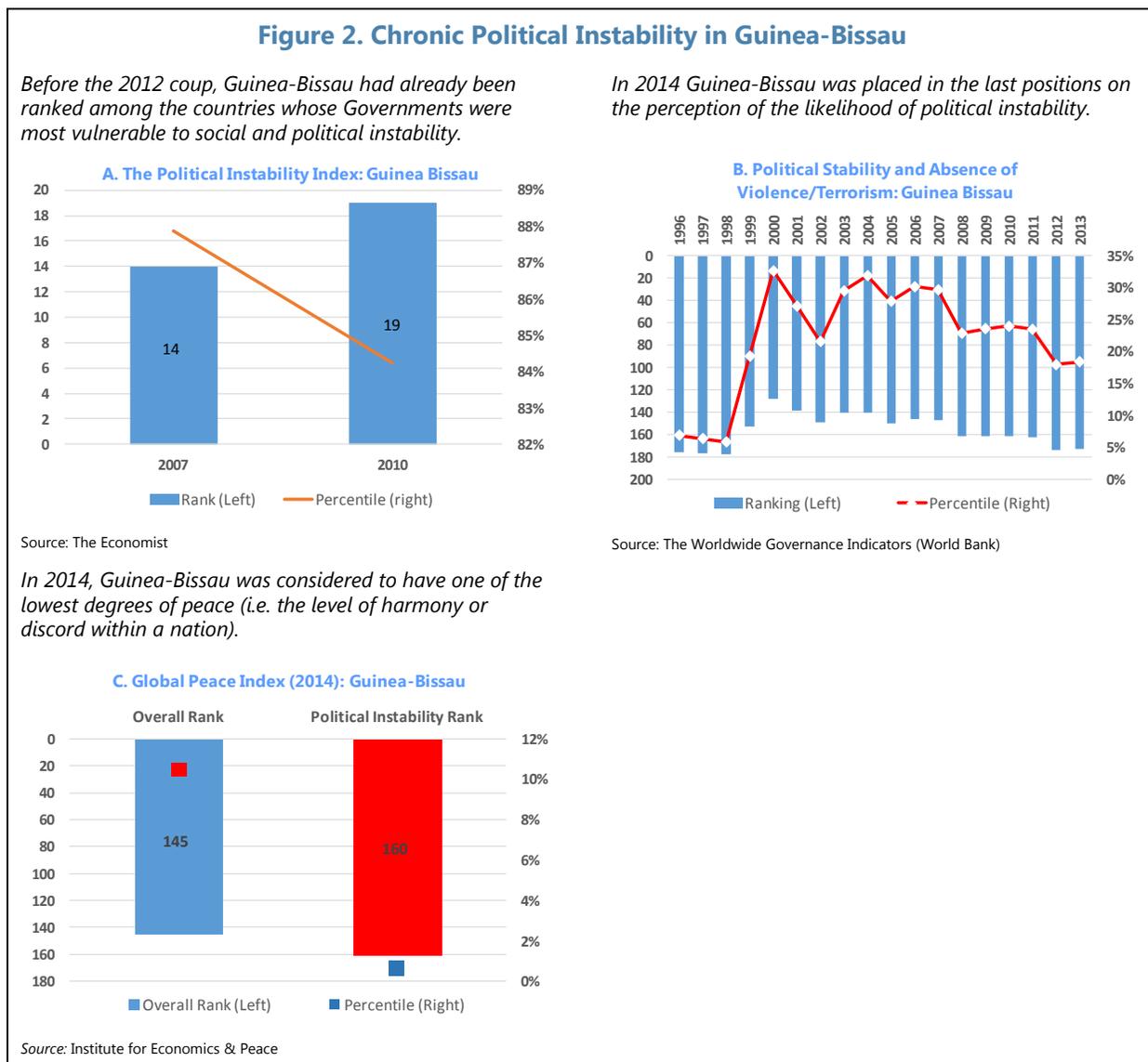
4. **The literature on the causes and costs of fragility has paid particular attention to violent conflict as one of its major causes.** The bulk of that literature focuses on the costs of violent conflicts, typically civil wars. Undoubtedly, the harmful consequences of violent conflicts are self-evident, be it in the destruction of physical capital or in the loss of numerous lives. In this regard, Abadie and Gardeazabal (2003) estimated the costs of the terrorism in the Basque country, and found that over 30 years the region's GDP per capita could have been 10 percent higher. Lopez and Wodon (2005) concluded that, had the 1994 genocide not existed, Rwanda's GDP (back in 2001) could have been 25 percent higher. Collier (1999) estimated that, on average, during civil conflicts the economy's annual growth rate reduces by about 2.2 percent. Moreover, Bigombe et al. (2000) found that, in Africa, there is a 50 percent chance of civil conflict recurrence within the ten years after reaching peace. In its turn, Akkaya et al. (2011) estimated the monetary costs for Palestine of the long Israeli-Palestinian conflict and found them to be very significant.



5. **Nonetheless, there is another type of conflict—many times not involving any loss of lives—that also impinges large costs on an economy and on a country's social fabric.** This type of conflict stems from political instability in its most extreme forms: a *coup d'état*. Its costs are not as explicit as those stemming from longer violent conflicts are, even so it is a powerful growth deterrent as well. It stands out for three main reasons. First, like civil wars, *coups d'état* are discrete events that can produce important throwbacks on growth and development prospects. Second, unlike civil wars, its true costs are not obvious to the general population, which makes it harder for a society to build an effective social technology (or consensus) to curb it. Third, in spite of that, like

civil wars, chronic political stability is subject to sudden stops if a wide internal understanding about its harmful effects emerges.

6. **Chronic political instability has been a hallmark of the Guinea-Bissau’s society (Figure 1).** An important hurdle behind fragility, chronic political instability, could, in principle, be overcome not within a generation but rather within a much shorter time span. Unfortunately, despite this theoretical possibility, the assessment made by Bigombe *et al.* (2000) on the high probability of recurrence of civil wars has also proven to be valid to *coups d’état*. Indeed, at least in the Guinea-Bissau case, *coups d’état* and attempts to break the constitutional order have been pervasive.



7. **Guinea-Bissau is one of the most politically unstable countries in the world.** As Figure 2 shows, back in 2010, that is, before the last *coup*, the country had already been ranked among the 20 most vulnerable countries to political instability (panel A). Moreover, other instability proxies

show that the situation has deteriorated further in recent years. Since early 2000s, there has been an increase in the probability assessment of political instability (panel B), and last year Guinea-Bissau was considered to be among the 10 percent of countries with the lowest levels of peace.

C. Chronic Political Instability and Fragility

8. **Recurrent *coups d'état* lead to a failing state.** The reasons why political instability—in the form of recurrent *coups d'état*—is so harmful lies in the very fact that the motivation behind breaking the constitutional order is the worst possible. Recurrent *coups d'état* reflect a society in which the relentless pursuit of power, and rent seeking at any cost, are pervasive, leading to the dismantling of the state or, in other words, to a failing state. It reflects the *de facto* absence of any meaningful and binding social contract.

9. **The transition period after *coups d'état* is particularly harmful.** From the moment a *coup d'état* takes place to the resumption of democratic normalcy, corruption and rent seeking soar, vested interests prevail, governance shatters, and weak institutions degrade further. During this transition period, adverse selection works at its best (or, better, at its worst). Corruption becomes epidemic and materializes in several ways, from plain stealing of public resources to loose enforcement of the law (e.g. less fiscalization). In addition, laws and regulations change or are overlooked to benefit groups and individuals (e.g. tax exemptions and fiscal amnesty).

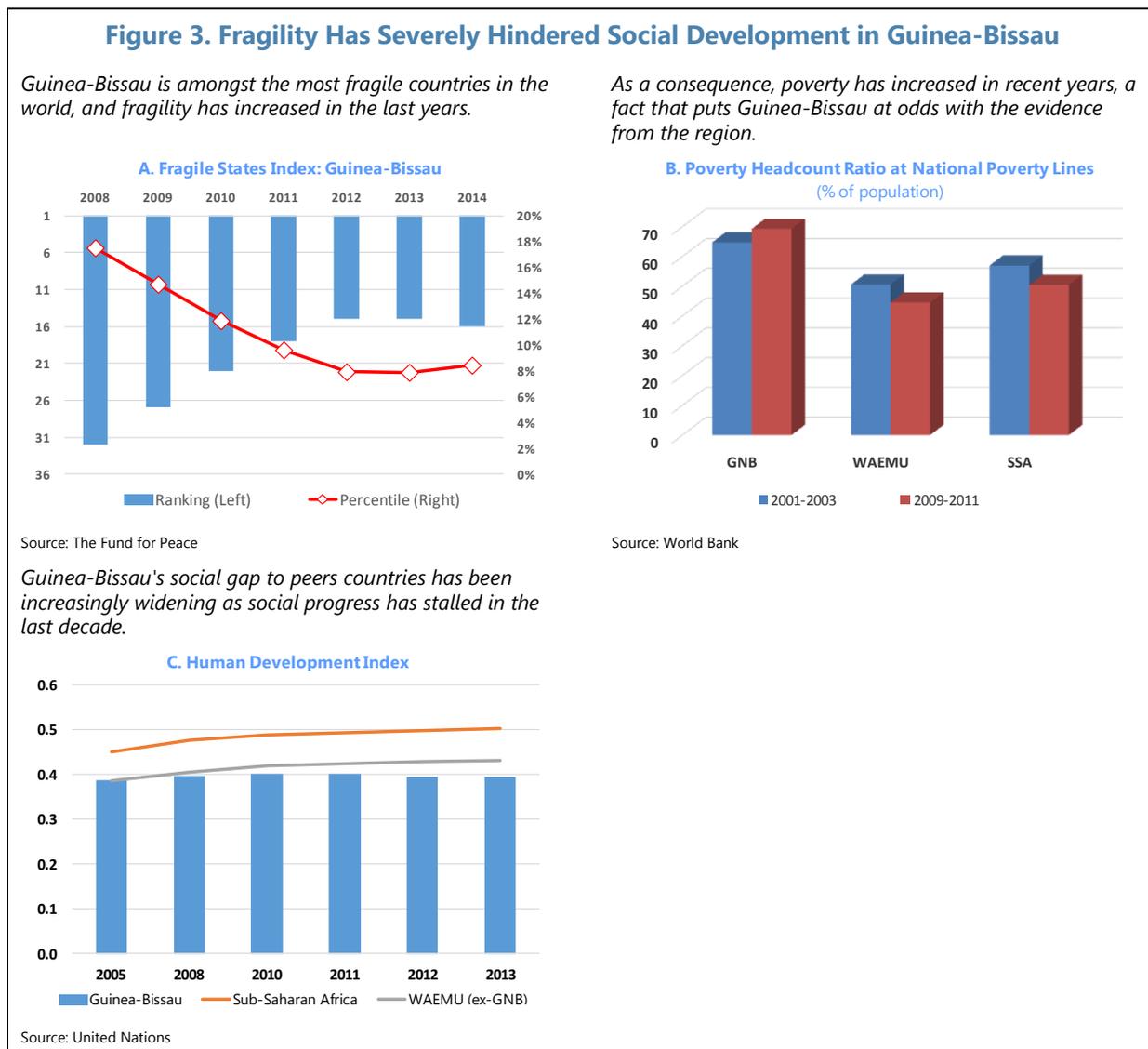
10. **The incentives facing transition governments do not align to those of the population.** Governance sharply worsens during transition periods, as regardless of whether the government does a good job or not, it is not entitled to reelection. Indeed, a successful transition government is precisely a short one, but the agenda behind the *coup* is about staying in power. Accountability is also impaired, as the transition government was not elected through voting. Finally, chronic political instability means that public policies are often discontinued hampering reforms and long term planning.

11. **Transition periods often last long.** Adverse (self) selection and perverse incentives help to explain why transition governments often stay so long in power. The most recent transition period in Guinea-Bissau persisted for more than two years, while the country was slowly sinking. It also helps in understanding the low effectiveness of some advocated responses to tackle fragility. For example, one suggestion found in the literature is for the international community to invest in state capacity building. The recent Bissau-Guinean experience, however, has shown that even intense technical assistance is unable to get traction in helping building institutions² in an environment where low human capital melts with brittle institutions, widespread rent seeking behavior and corruption.

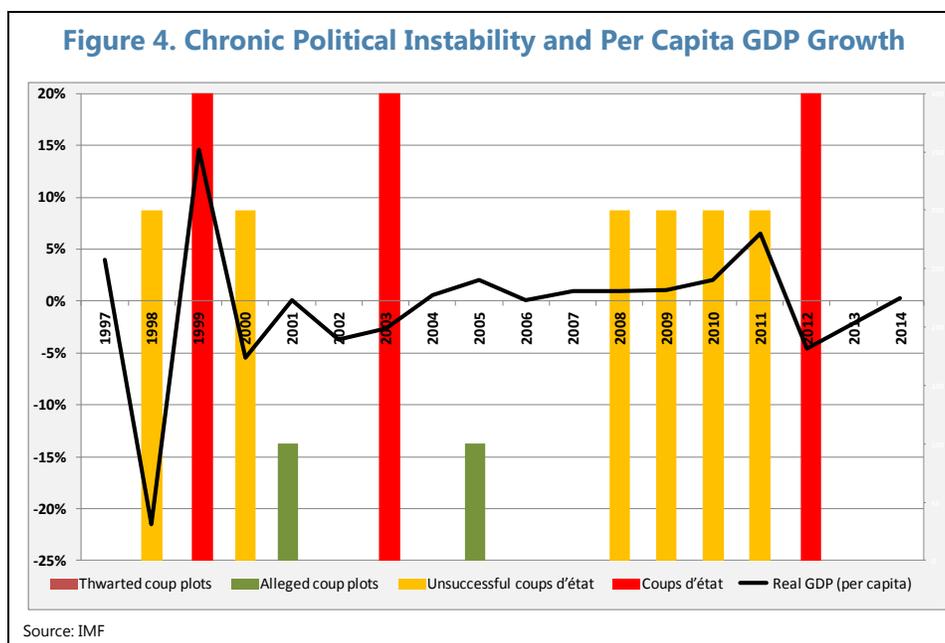
12. **Guinea-Bissau has failed to provide basic public services to its citizens.** Figure 3 shows striking evidence on the failure of a fragile state to provide basic public services to its citizens.

² See findings in technical assistance reports Kone *et al.* (2014); Pialarissi *et al.* (2014); Russell and Calvet (2014).

Guinea-Bissau not only remains as one of the most fragile countries in the world (panel A), but also has not been able to keep up with its peers. Poverty has increased in the last decade, in sharp contrast to the regional evidence (panel B). Consequently, human development has stalled, and the country is increasingly lagging behind its peers (panel C). The above results are even more meaningful when one realizes that these rankings also include countries involved in wars. It should be clear by now that Guinea-Bissau will miss the Millennium Development Goals.



13. **Guinea-Bissau’s Per Capita GDP has stagnated since 2000.** Given that social progress depends on economic performance, one should expect very modest figures for Guinea-Bissau’s GDP growth. Disregarding the sharp drop and recovery due to the 1998–99 civil war, real GDP per capita growth has been hovering around zero since 2000 (Figure 4). More specifically, note that the heightened instability in 2000 had a clear impact on growth, and the GDP loss associated with the 2012 coup was significant.



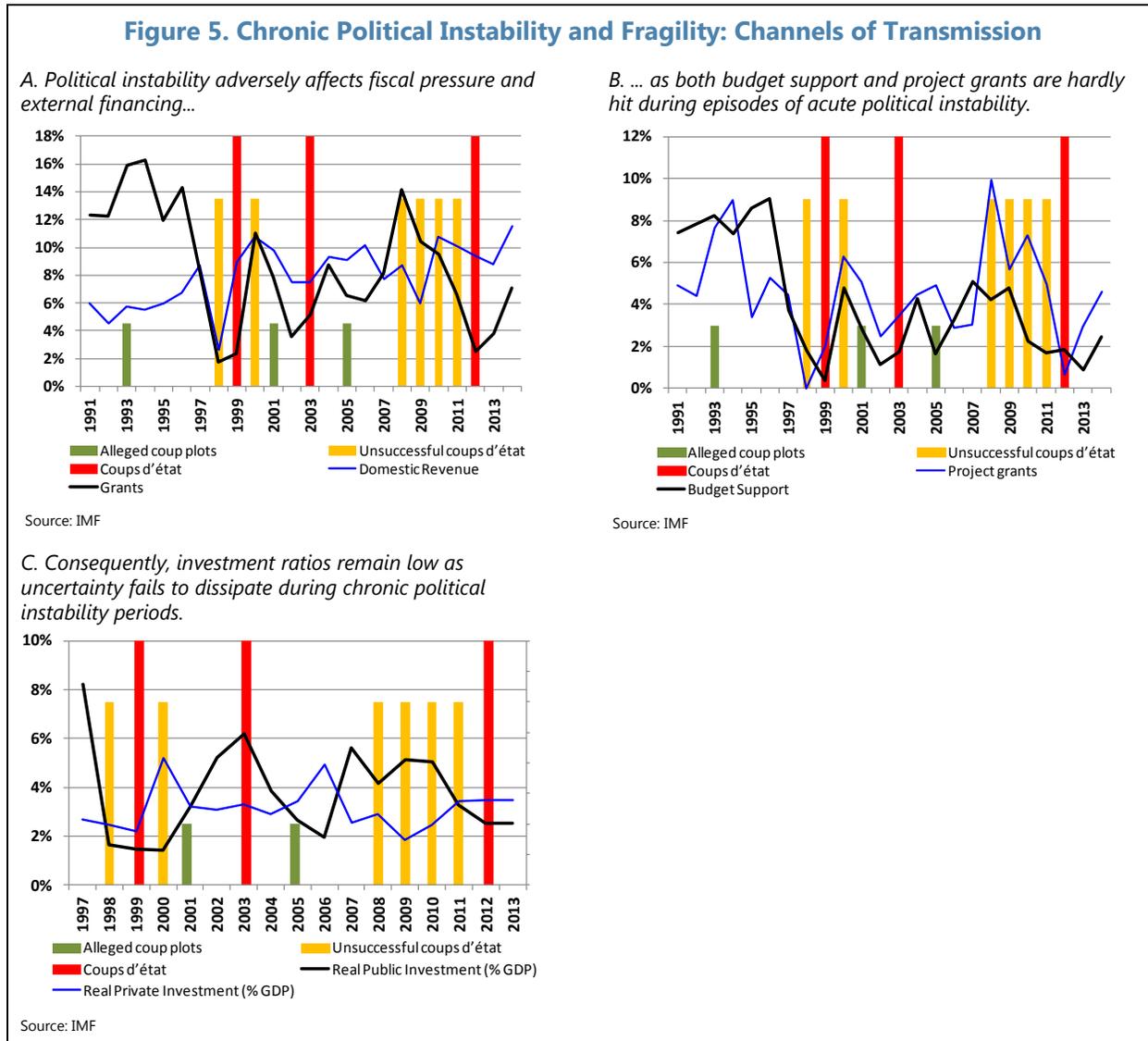
D. Chronic Political Instability: Key Channels of Transmission

14. **Chronic political instability is detrimental to growth in several ways, but measurement is challenging.** Some channels, by their own nature, are hard to measure, such as wasted resources due to corruption and rent seeking, or the inefficiency caused by non-optimal decisions due to bad governance. Corruption, bad governance and policy discontinuity are also powerful deterrents to reforms. In their report on structural reforms in customs, Russell and Calvet (2014) warn: “This mission could not observe any progress in resolving identified recurrent problems since 2012 [the year of the last *coup*]”.³ The growth effects of the non-implementation of reforms are difficult to measure, despite their large importance to economic performance. On the other hand, other channels are easier to capture.

15. **Financing and investment are two key transmission channels from political instability to fragility.** During periods of acute political instability domestic revenues and grants decline, particularly the latter (Figure 5, panels A and B). That further reduces the already limited government’s capacity to spend and invest (panel C). The decline in public investment is particularly steep in the three years following the 2003 *coup*. In addition, after a rebound, public investment sharply declined again during the turbulent 2008–13 period. Although the dynamics of private investment is not as timely as that of public investment, note that its level remains low throughout the sample, reflecting the endemic uncertainty that entrepreneurs face in Guinea-Bissau. Moreover, the microeconomics of both types of investment is different. Public investment dynamics basically

³ Author’s translation.

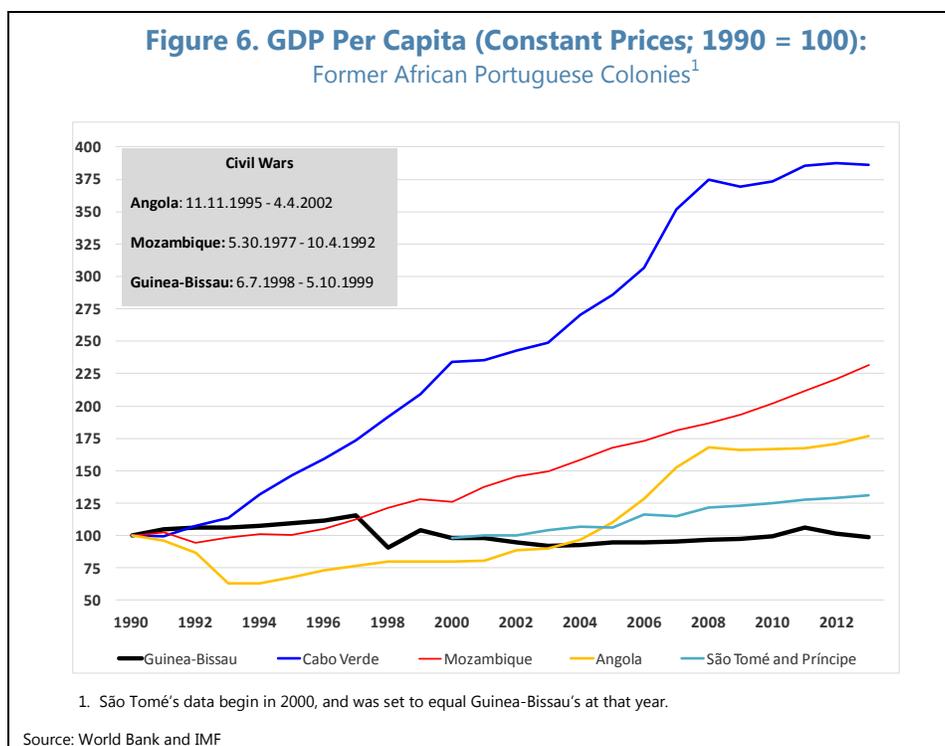
mimic the availability of resources (i.e. grants); while on the other hand, one would expect the funding of private investment to decline before it takes place.⁴



⁴ There are serious data limitations as private investment is often a residual.

E. The Cost of Chronic Political Instability

16. **Until today, Guinea-Bissau has been stuck in a fragility trap.** Economic growth has stalled since 2000. This outcome is *per se* appalling evidence. However, it does not say anything about Guinea-Bissau's relative performance, or to put it differently, about the true economic cost of political instability. Figure 6 compares Guinea-Bissau's economic performance with those of former Portuguese colonies in Africa, and the evidence is jaw-dropping. Guinea-Bissau has not only been stagnant, but is being increasingly left behind by the other former colonies.



17. **Guinea-Bissau's development path could have been similar to other former African Portuguese colonies.** Obviously, even though each country has its own history and characteristics, those differences can sharpen this qualitative assessment, and some are worth mentioning. First, Guinea-Bissau was the first Portuguese colony in Africa to become independent. One would expect this to have a positive effect on growth. Second, even though São Tomé and Príncipe and Cabo Verde did not have civil wars—which evidently helped their development—both Angola and Mozambique went through very long and destructive civil wars, while Guinea-Bissau's civil war lasted only eleven months.⁵ Moreover, unlike Guinea-Bissau, after the war ended those two

⁵ On the other hand, São Tomé and Príncipe is a very small island, which certainly hinders its growth prospects.

countries began to grow faster, catching up with their peers.⁶ In Guinea-Bissau, after the end of the civil war, growth, that had already been poor before the war, deteriorated further.

18. **What could have been the economic performance in GNB in the absence of chronic political instability?** A reliable answer is very difficult, but two simple and feasible counterfactuals could be very useful in providing an idea on the magnitude of the “instability gap”. The first one assumes that Guinea-Bissau’s real GDP per capita could have grown, on average, at the same pace as the average real GDP per capita growth in the other former Portuguese colonies, during 2000–13. The second counterfactual assumes an average growth rate equal to the one achieved by the so-called low-income countries (LIC). This is a sensible counterfactual, given that those countries have faced several constraints and challenges relevant for Guinea-Bissau. They should provide a plausible interval estimate of what could have feasibly been the average growth in Guinea Bissau in the absence of chronic political instability during the 2000–13 period.

Table 1. Estimates of the Cost of Chronic Political Instability on GDP Per Capita during 2000–13 (in percent)			
	GDP Growth	Annual Growth Cost	Total Growth Cost
Actual	-0.3%	–	–
Counterfactual 1	4.3%	4.7%	89.5%
Counterfactual 2	3.3%	3.6 %	65.2%

19. **The estimated “instability gap” is substantial (Table 1).** Without a history of chronic political instability Guinea-Bissau’s GDP per capita at constant prices in 2013 could have been higher between 65% and 90%. Note that this interval reflects a difference built since 2000 (i.e. after the end of the civil war). The loss in GDP growth would be even more significant if we also included in the estimate the effects of the civil war.

F. Conclusion

20. **Until today, Guinea-Bissau has been stuck in a fragility trap.** Although fragility is a multidimensional condition, chronic political instability—in the form of recurrent *coups d’état*—has been a major factor hampering growth and social progress in Guinea-Bissau. GDP per capita has been stagnant for more than two decades. Not surprisingly, peer countries have increasingly left Guinea-Bissau behind.

21. **The incentives behind recurrent *coups d’état* are the worst possible.** They reflect a society in which the relentless pursuit of power and rent seeking at any cost is the norm. There is a

⁶ Angola’s economic performance has benefited from oil discoveries.

clear problem of (self and forceful) adverse selection. After a long transition period—which truthfully reveals the main drivers behind *coups d'état*—Guinea-Bissau finds itself, once again, at a decisive moment: can it this time break from its past of instability?

22. **Estimates based on reasonable assumptions reveal that, considering only Guinea-Bissau's post-war period, without chronic political instability real GDP per capita could have been at least two thirds higher than its 2013 level.** This assessment shows the crucial importance of the security sector reform (and other governance-increasing, rent-seeking inhibiting reforms). It also shows that the current estimated cost of the security sector reform is modest in comparison, since it puts into perspective its monetary costs—which are easy to calculate and mostly front-loaded—vis-à-vis its wide and deep benefits, which are not as explicit and accrue over time.

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EXTERNAL STABILITY ASSESSMENT¹

After severe balance of payments pressures in 2012 and 2013, due to a decline in the international price of cashew, Guinea-Bissau's main export product, combined with political uncertainty after the 2012 coup, exports have recovered and support by international partners has returned. While imports have also been strong, a significant increase in current transfers moderated the current account deficit in 2014, and the balance of payments recorded an overall surplus. In the medium-term, financing needs would increase significantly as terms-of-trade are projected to deteriorate and import demand to remain strong due to continued robust growth and large—mainly officially funded—infrastructure investment needs. The real effective exchange rate appears broadly in line with fundamentals in the short-term. The economy remains vulnerable to shocks due to high export concentration and the country's fragile status. The business environment remains difficult. To safeguard external stability in the medium term, policies targeting the diversification of the economy combined with improvement in non-price competitiveness will be critical.

A. Recent Economic Developments and Outlook

1. Pressures on Guinea-Bissau's balance of payments moderated significantly in 2014

(Figure 1). After severe external pressures due to the decline of cashew nut prices by more than 40 percent between 2011 and 2013, Guinea-Bissau's terms of trade improved by more than 30 percent in 2014, and exports recovered. Imports also grew substantially (by almost 31 percent in real terms), driven by a more favorable growth outcome and substantial demand for fuel. As a result, the trade deficit widened from 7.7 percent of GDP in 2013 to 9.7 percent in 2014. Current transfers more than doubled in nominal terms compared to their 2013 level and reached 7 percent of GDP due to a strong increase in budget grants and continued robust private transfers. Consequently, the current account deficit including grants is estimated to have declined to 1.2 percent of GDP in 2014, down from 4.4 percent in 2013. The balance of payments recorded a significant surplus.

2. Financing needs are expected to increase in the medium term, driven by a scaling up of public investment and a weakening in the terms of trade (Figure 2). Large public investments, financed through project grants and concessional borrowing, and a further increase of real growth to around 5 percent would boost imports in the medium-term. Exports values, while projected to rise significantly due to a favorable outlook for cashew prices in 2015, would stay relatively flat in the medium term. The current account deficit would expand to an average of more than 5 percent of GDP per year during 2015–19. The current account deficit would be driven on average mainly by a public savings-investments gap, while the private savings-investments gap would decline as well.

¹ Prepared by Monique Newiak.

3. Guinea-Bissau’s external position remains vulnerable to a range of risks. A stable political and security situation is the necessary condition for a sustainable external position. From the macroeconomic perspective, Guinea-Bissau’s very high export concentration in cashew nuts (85 to 99 percent of exports) poses the main risk to external stability as it leaves the country vulnerable to international price fluctuations. An increase in currently favorable oil prices could exert pressure on the current account as the economy is highly dependent on the import of petroleum products. In the medium term, continued flows of grants and access to concessional loans will be necessary to finance huge infrastructure development needs which in turn constitute the precondition for developing Guinea-Bissau’s export base.

B. External Sustainability Assessment

Based on the external balance assessment for developing and emerging markets (EBA-lite), Guinea-Bissau’s real effective exchange rate (REER) appears to be broadly in line with the country’s fundamentals.

4. To assess the stance of the current account for Guinea-Bissau, this note uses the “EBA-lite” methodology (Figure 3). The fitted values resulting from this exercise capture the current account deficit dynamics well, but there are substantial differences between the actual current account in percent of GDP compared to the levels implied by the regression. In the more recent years, the implied levels exceed the actual levels, implying that countries with similar characteristics, such as demographics, institutions and size of private and public transfers and fiscal stance, openness to trade and terms of trade movements, have, on average, experienced somewhat lower current account deficits.

5. Based on the EBA-lite approach, Guinea-Bissau’s current account stance in 2015 can be decomposed as follows:

$$\text{Actual CA} = \text{CA Gap} + \underbrace{(\text{Fitted CA} - \text{Policy Gap})}_{\text{CA Norm}}$$

in which *CA Gap* is the current account misalignment, *Fitted CA* is the predicted value from the regression above and *Policy Gap* relates a country’s actual policies not only to its optimal policies, but also to the average policy misalignment in the rest of the world.

6. For most policies, staff expects no policy gap for Guinea-Bissau in 2015. On the national level, this note assumes that the projected cyclically adjusted fiscal stance, the degree of capital controls and the accumulation of official net foreign assets is in line with staff’s recommendations, so that any policy gaps incorporated into the approach would stem from differences in policies compared to the rest of the world. For the level of credit to the private sector to GDP, however, a benchmark level of 22 percent is set as the optimal “policy” variable, in line with its benchmark level obtained Section III on financial stability, depth and inclusion, and which is substantially above the projected level of private sector credit to GDP of 11 percent of GDP in 2015.

7. The EBA-lite approach suggests that Guinea-Bissau's REER would be broadly in line with its fundamentals in 2015. The current account benchmark implied by the EBA-lite approach is -2.7 percent of GDP, of which -1.5 percent of GDP are driven by the policy gap and another -1.2 percent by Guinea-Bissau's macroeconomic fundamentals. The actual current account deficit is projected to rise to 3.6 percent of GDP in 2015. The implied misalignment of the current account is therefore -0.9 percent of GDP, implying a statistically insignificant 6.5 percent over-valuation of the REER.² Such an over-valuation is considered to be within the margin of error, and the REER thus appears to be broadly in line with the Guinea-Bissau's fundamentals.

8. As Guinea-Bissau's is part of a monetary union, its exchange rate should also be seen in the context of the external stability of the WAEMU as whole (IMF, 2015b). As a member of a currency union, and being the smallest player in it, Guinea-Bissau's external position also depends on the other WAEMU members' performance. An assessment of the WAEMU as a whole suggests that the external position remains sustainable but vulnerabilities have increased. The region's exchange rate appears broadly in line with fundamentals, but its external buffers have been shrinking: the BCEAO's gross international reserves (GIR) coverage decreased from 6.6 months of imports in 2010 to 4.6 months of imports in 2014; commercial banks' net foreign exchange position has declined significantly in 2014 and turned negative. The level of GIR is below optimal based on standard metrics (5 to 12 months of imports).³ However, GIR are still significantly higher than the floor that acts as a warning signal under the zone's monetary arrangement with France (84 percent of narrow money compared with 20 percent).

C. Non-Price Competitiveness

9. The business climate in Guinea-Bissau remains difficult (Figure 4 and 5). Guinea-Bissau's relative rating in the Doing Business ranking has deteriorated compared to the last assessment; only 10 out of 189 countries evaluated are currently ranked worse.⁴ Getting access to electricity, starting a business and enforcing contracts are particularly challenging areas compared to other WAEMU countries and a benchmark group of fast growing African economies.⁵ Guinea-Bissau's institutions and policies are also consistently ranked weaker than in other WAEMU countries in the Country Policy and Institutional Assessment. Considering that Guinea-Bissau cannot devalue its currency as it is part of a monetary union, improvements in these areas will be even more critical for the private

² $-3.6 - (-2.7) = -0.9$. The assumed elasticity of the current account to movements in the real exchange rate is -0.13.

³ Given the commitment of France to back the convertibility of the CFA franc this metric does not fully apply for the WAEMU. For details on the metric, see Dabla-Norris, Kim and Shorono (2011): "Optimal Precautionary Reserves for Low-Income Countries: A Cost-Benefit Analysis," International Monetary Fund, Working Paper WP/11/249.

⁴ Doing Business indicators should be interpreted with caution because of the limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

⁵ These benchmarks include Ghana, Kenya, Lesotho, Rwanda, Tanzania, Uganda, and Zambia.

sector's development and economic diversification which are the necessary conditions to make Guinea-Bissau an economy which is more resilient to shocks (Section IV).

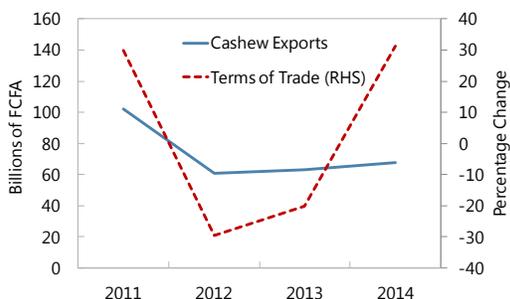
D. Conclusions

10. The REER appears broadly in line with fundamentals, improvements in non-price competitiveness will be necessary to safeguard stability in the medium term. Based on the external balance assessment for developing and emerging markets (EBA-lite), Guinea-Bissau's real effective exchange rate (REER) appears to be broadly in line with the country's fundamentals. However, the economy remains exposed to shocks due to high export concentration and the country's fragile status, and the business environment remains difficult. To safeguard external stability in the medium term, policies targeting the diversification of the economy combined with improvement in non-price competitiveness will therefore be critical.

Figure 1. Guinea-Bissau: Recent External Developments

After a sharp decline the last two years, cashew nut exports recovered in 2014, ...

Terms of Trade and Cashew Exports, 2011-2014
(Percentage Change and Billions of FCFA)



Sources: Guinea-Bissau authorities; and IMF staff estimates.

... but the trade balance deteriorated slightly due to higher imports driven by higher growth and external financing.

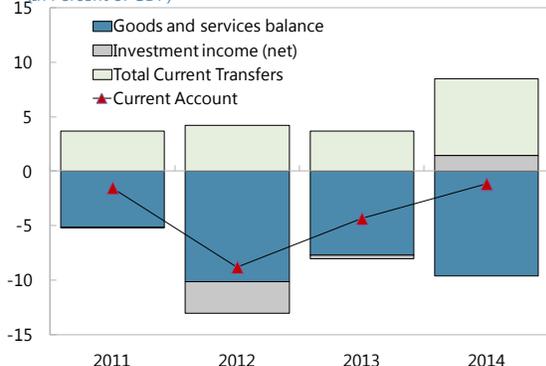
Trade Balance, 2011-2014
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities and staff estimates.

The current account balance is estimated to have improved substantially due to higher current transfers, ...

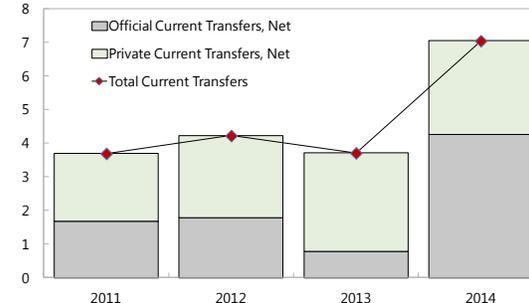
Current Account Balance, 2011-2014
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities; and staff estimates.

... driven mainly by a resumption in support by official international partners.

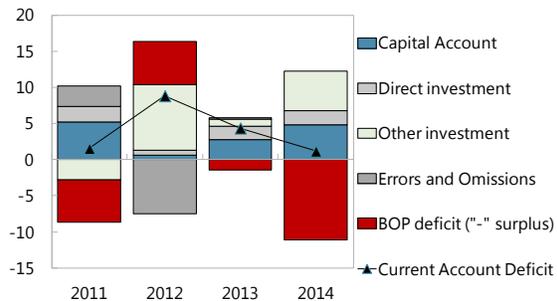
Current Transfers, 2011-2014
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities and staff estimates.

With an increase in official financing (other investment), the balance of payments recorded a substantial surplus, ...

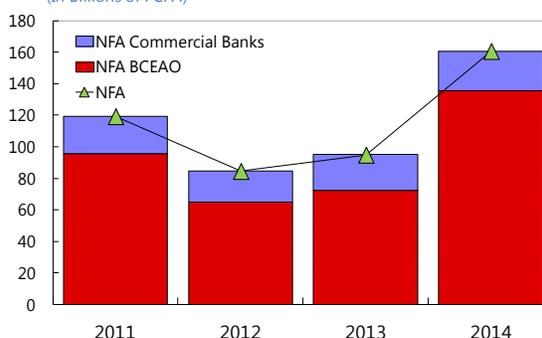
Sources of Financing, 2011-2014
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities; and staff estimates.

... so that imputed net official assets increased significantly in Guinea-Bissau, as did commercial banks NFA.

Net Foreign Assets, 2011-2014
(In Billions of FCFA)

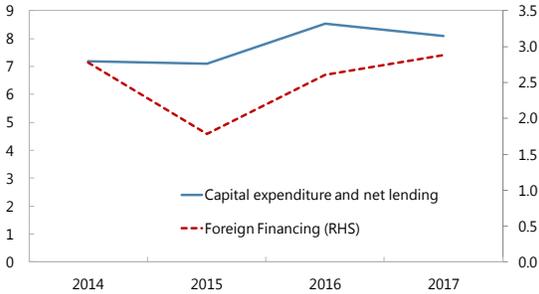


Sources: BCEAO and Guinea-Bissau authorities .

Figure 2. Guinea-Bissau: External Outlook

Foreign financing and associated investment plans are expected to increase strongly in the medium-term ...

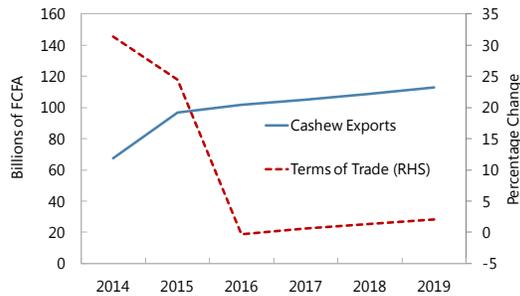
Public Capital Expenditure and Foreign Financing
(In Percent of GDP)



Sources: Guinea-Bissau Authorities and IMF staff estimates and projections.

The value of cashew exports is projected to remain flat, given somewhat weaker terms of trade.

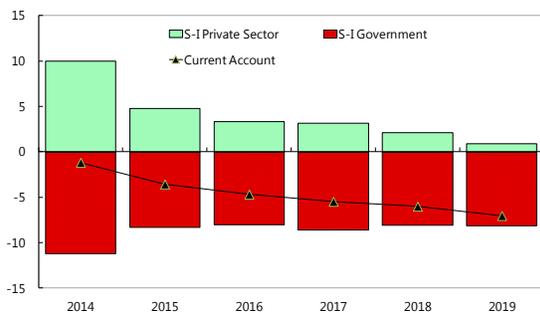
Terms of Trade and Cashew Exports, 2014-2019
(Percentage Change and Billions of FCFA)



Sources: Guinea-Bissau authorities; and IMF staff estimates/projections.

... with pressure arising mainly from the public sector but also from a declining private savings-investments balance.

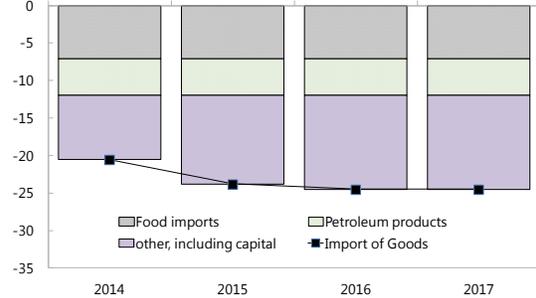
Drivers of the Current Account Deficit, 2014-2019
(In Percent of GDP)



Sources: Guinea-Bissau authorities; and staff estimates/projections.

... boosting imports of capital goods into the country.

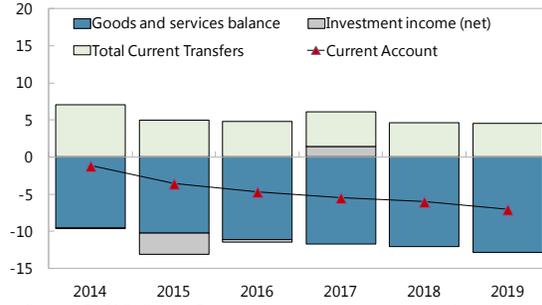
Goods Imports, 2014-2019
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities and staff estimates/projections.

As a result, the current account deficit would widen substantially in the medium-term, ...

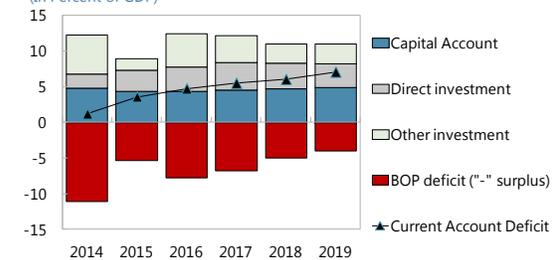
Current Account Balance, 2014-2019
(In Percent of GDP)



Sources: BCEAO, Guinea-Bissau authorities; and staff estimates/projections.

The BOP surplus would decline.

Sources of Financing, 2014-2019
(In Percent of GDP)



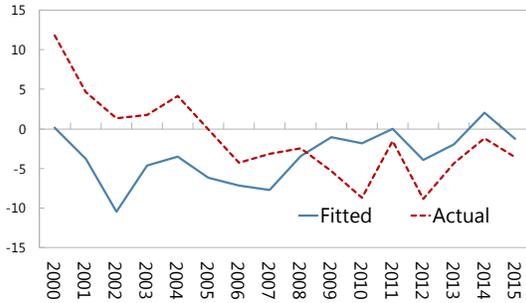
Sources: BCEAO, Guinea-Bissau authorities; and staff estimates/projections.

Figure 3. Guinea-Bissau: External Stability Assessment

The EBA-lite regression fits the dynamics of the current account quite well.

Current Account, 2009-2015

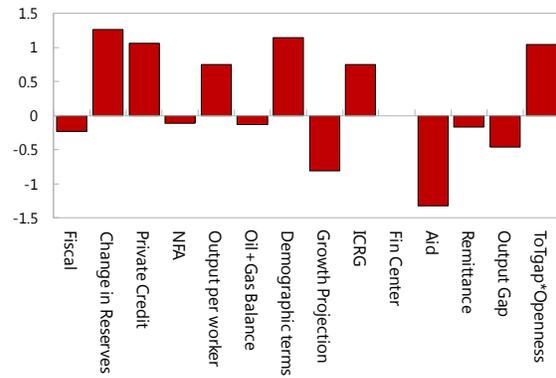
(In Percent of GDP)



Terms of trade, openness, private credit and aid flows are among the dominant determinants of the current account.

Drivers of the Current Account, 2015

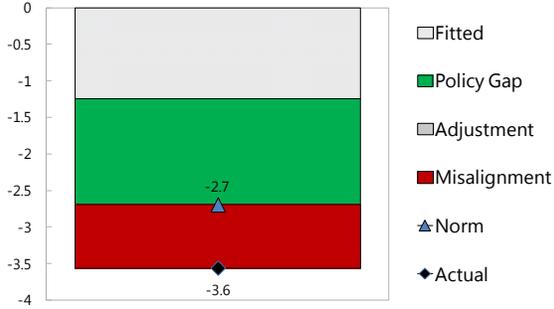
(In Percent of GDP)



Guinea-Bissau's current account appears is expected to be broadly in line with fundamentals in 2015.

Current Account Decomposition, 2015

(In Percent of GDP)



The policy gap is driven by low credit by the private sector and the fiscal stance relative to the rest of the world.

Drivers of the Policy Gap

(In Percent of GDP)

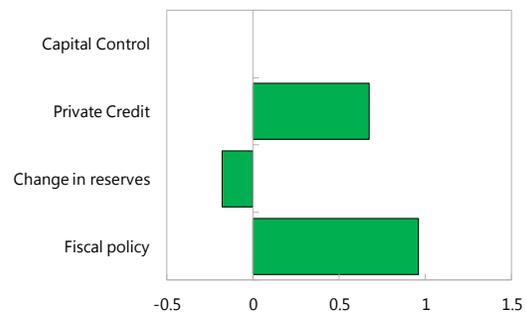
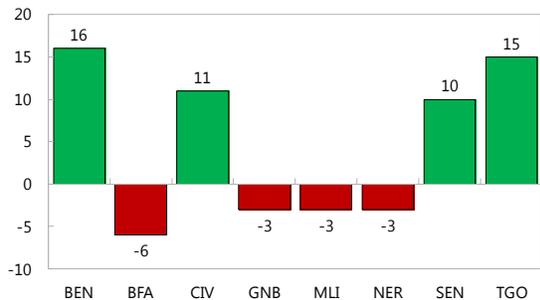


Figure 4. Guinea-Bissau: Doing Business and Access to Communication Infrastructure

Guinea-Bissau's Doing Business rating has deteriorated, ...

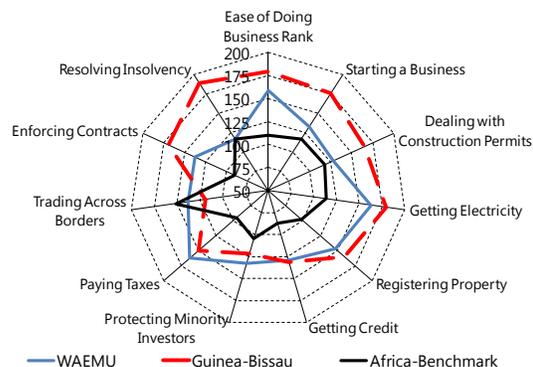
Improvement in Doing Business Ranking
(In Number Ranks)



Sources: World Bank, Doing Business 2015.

... and its rating is worse than that of other WAEMU countries in almost all rated dimensions.

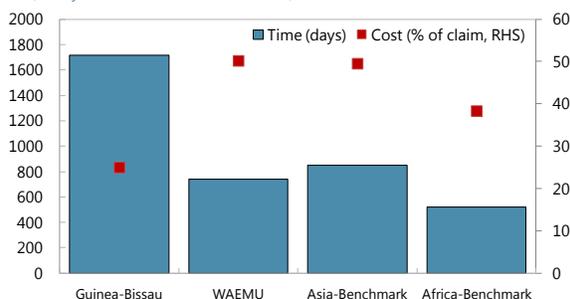
Ease of Doing Business 2015
(Rank among 189 Economies)



Sources: World Bank, Doing Business 2015

Contract enforcement is relatively cheaper than in other WAEMU countries but takes more time in Guinea-Bissau.

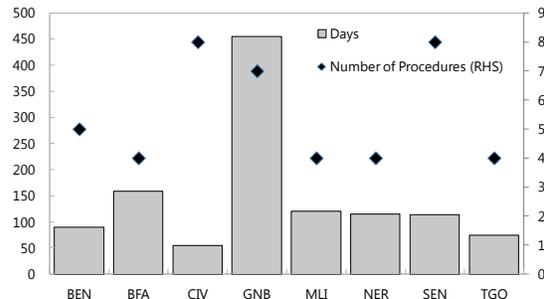
Effort Needed to Enforce Contracts
(In Days and Cost in Percent of Claim)



Source: World Bank, Doing Business 2015.

Obtaining access to electricity is even more difficult than in the rest of the WAEMU region.

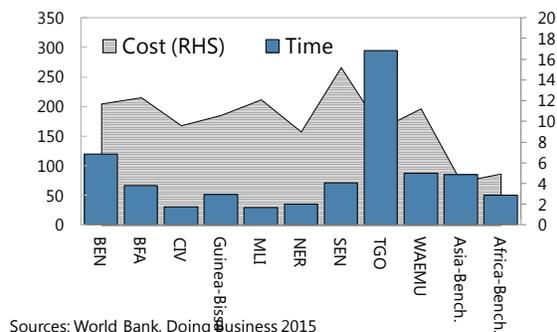
Effort Needed to Get Electricity
(In Days and Number of Procedures)



Sources: World Bank, Doing Business

The cost and time needed to register property is lower than in the WAEMU on average.

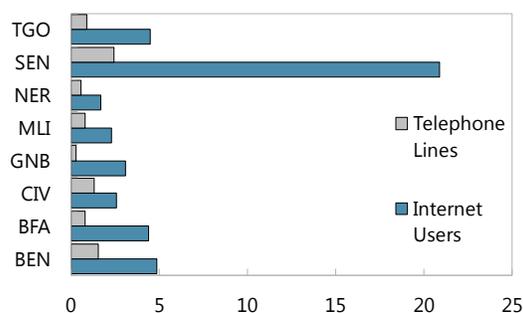
Registering Property
(Time in Days, Cost in Percent of Property Value)



Sources: World Bank, Doing Business 2015

Access to communication infrastructure is low.

Telephone Lines and Internet Users, 2013
(Per 100 People)

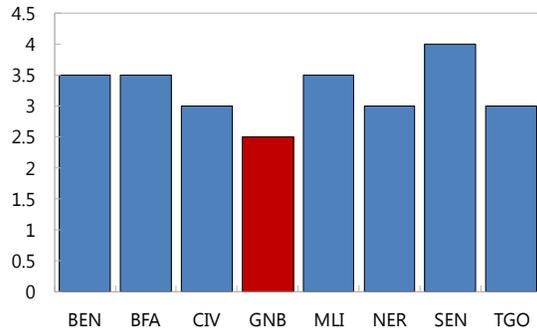


Sources: World Bank, World Development Indicators.

Figure 5. Guinea-Bissau: Country Policy and Institutional Assessment

Business and Regulatory Environment, 2013

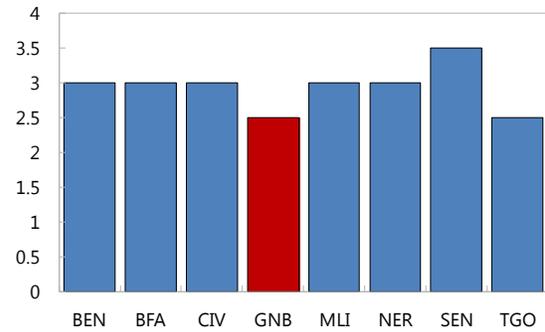
(1= low to 6 = high)



Sources: World Bank Group, CPIA database.

Financial Sector Rating, 2013

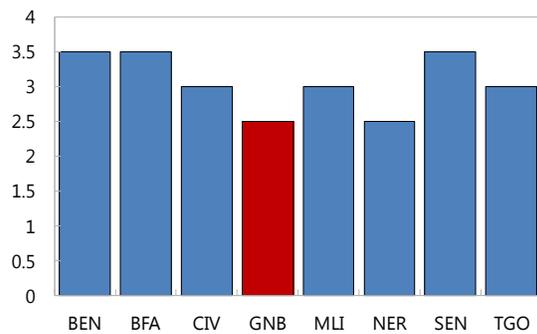
(1= low to 6 = high)



Sources: World Bank Group, CPIA database.

Gender Equality Rating, 2013

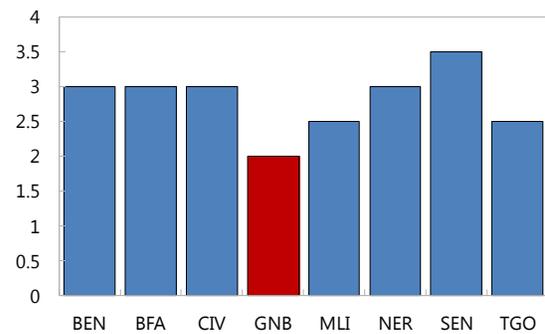
(1= low to 6 = high)



Sources: World Bank Group, CPIA database.

Protey Rights and Rules Based Governance, 2013

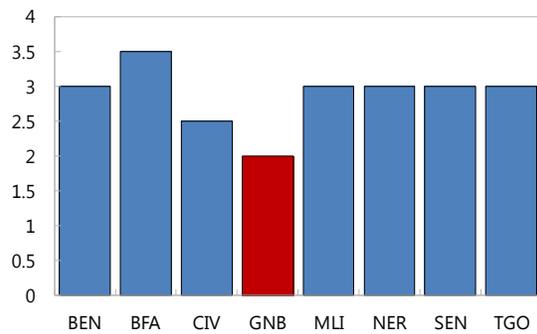
(1= low to 6 = high)



Sources: World Bank Group, CPIA database.

Social Protection Rating, 2013

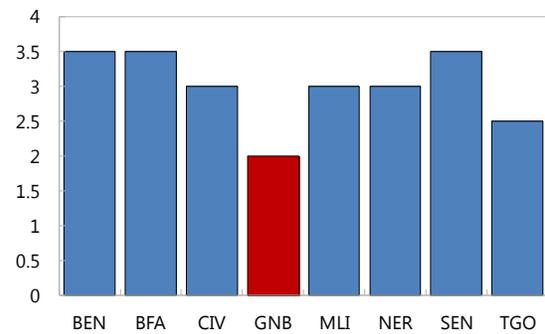
(1= low to 6 = high)



Sources: World Bank Group, CPIA database.

Transparency, Accountability and Corruption, 2013

(In the Public Sector, 1= low to 6 = high)



Sources: World Bank Group, CPIA database.

FINANCIAL STABILITY, INCLUSION, AND DEEPENING¹

Guinea-Bissau's financial sector remains shallow, faces major challenges, and access to financial services is low. Most indicators of financial soundness point to vulnerabilities in Guinea-Bissau's financial system, financial depth appears to be below the level implied by the country's characteristics, and access to financial services is limited. Commercial banks are on average less profitable and less liquid, face higher non-performing loans and are less compliant to key prudential ratios than banks in other WAEMU countries. While financial intermediation has picked up recently, credit to the private sector remains lower than implied by the country's fundamentals. Access to financial services in Guinea-Bissau is low and the banking sector only marginally contributes to firms' investment programs. This note reviews the state of financial stability and inclusiveness and argues that: (i) financial stability issues need to be addressed at the national and regional levels, (ii) social spending and infrastructure investments will be essential to deepen the financial market, and (iii) while the use of mobile payment services could make financial services more accessible to a wider population in the short-term, stronger financial inclusion in the medium term will require major improvements in the business environment and financial literacy.

A. Financial Sector Stability

- 1. Financial stability indicators point to a vulnerable banking sector; concentration risk poses the main problem (Figure 1).** As in other WAEMU countries, the financial sector in Guinea-Bissau is dominated by the banking sector. The banking sector encompasses currently four banks whose assets represent almost 32 percent of Guinea-Bissau's GDP. While the sector is well capitalized on average, with average solvency ratios above average WAEMU levels, there is considerable heterogeneity across banks, and most indicators of profitability and liquidity are weaker than in other WAEMU countries. Lending is concentrated in a few sectors. In particular, exposure to the cashew nut sector is very high and, as only a few companies are incorporated in Guinea-Bissau, the risk from this sector is concentrated on approximately 20 bankable agents.
- 2. Since international cashew nut prices started declining in 2012, and fueled by political uncertainty due to the 2012 coup, non-performing loans have increased significantly.** As Guinea-Bissau's economy is highly concentrated in cashew activity (more than a third of GDP and more than 90 percent of exports related to cashew activity), negative shocks to the sector can have significant impacts on balance sheets of commercial banks. Concentration risks related to other sectors are also high in some banks. When the price of cashew fell from almost 1400 USD/ton in 2011 to below 800 USD/ton in 2013, non-performing loans (NPLs) of the two banks with the largest exposure to the cashew sector increased to 60 and 74 percent as of September 2014. On average, the ratio of NPLs to total loans has increased from 6.5 percent at the end of December 2011 to

¹ Prepared by Monique Newiak.

37.7 percent in June 2014.² Consistently with existing regulation at the WAEMU level, provisioning has been slow. At the end of December 2014, considerable heterogeneity remained in the level of NPLs across banks (Figure 2).

3. An international best practice and market-based solution to curb NPLs and for recapitalization is underway and the government has thus succeeded in avoiding the use of scarce public funds for this purpose. Following technical assistance advice by the Fund, the government has refrained from providing public funds to the banks plagued by high levels of NPLs. Instead, the affected banks have started to seize collateral and one bank agreed with the Banking Commission on a phased increase in capital from CFA 5 billion to 20 billion. Going forward, it will be important for banks to also liquidate their seized collateral.

4. Compliance to other prudential indicators is also weak in Guinea-Bissau (Figure 2). Compliance with prudential norms remained weak in June 2014, even when compared to the modest compliance ratios in the WAEMU. Also due to the poor diversification of Guinea-Bissau's economy, only one of the four banks complied with the single exposure limit which is already high by international standards (75 percent vs. 25 percent). Half of the banks did not comply with the minimum capital requirement of FCFA 5 billion, the capital adequacy ratio of 8 percent, the related party lending ceiling, the liquidity ratio and the transformation ratio.

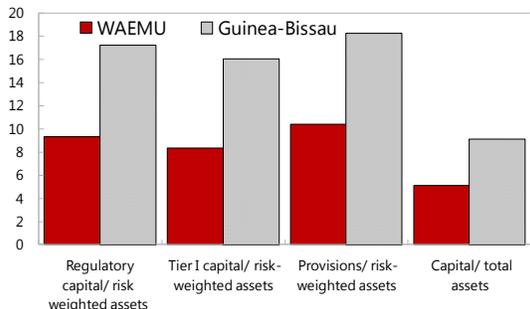
5. Compliance with key prudential ratios needs to improve to safeguard financial stability (IMF 2015a). To this end, action on both the regional and national level is required. Recent capacity building efforts at the Banking Commission need to be reinforced by strengthening risk-based supervisory tools and processes. Timely provision of data by the national BCEAO branches to the supervisory authorities will be essential in this regard. A stronger corrective action framework should be put in place in order to reduce regulatory forbearance and better enforce compliance with prudential norms, including by taking timely and effective corrective measures against weak and/or noncompliant banks. The move to Basel II/III standards will take time but will be an opportunity to bring prudential rules closer to international norms. In the mean time, the regional authorities should step up the enforcement of the current rules, as well as start tightening certain rules where improvements are most pressing, for instance on concentration risk and provisioning of non-performing loans.

² For consistency of the comparison between Guinea-Bissau and the WAEMU, the source of all financial soundness indicators (FSI) used in this note is BCEAO headquarter; these FSI may differ from the ones reported in the accompanying staff report.

Figure 1. Indicators of Financial Soundness

Indicators of solvency remain high but mask large variations across the country's four commercial banks.

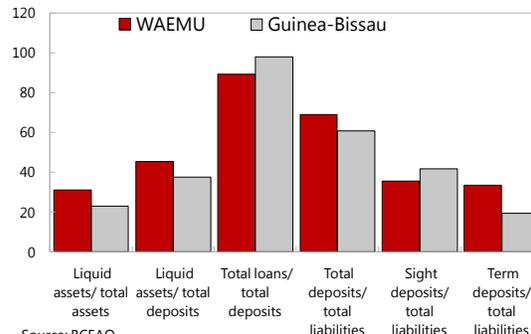
Solvency Ratios, June 2014



Source: BCEAO

Most liquidity ratios are below regional averages.

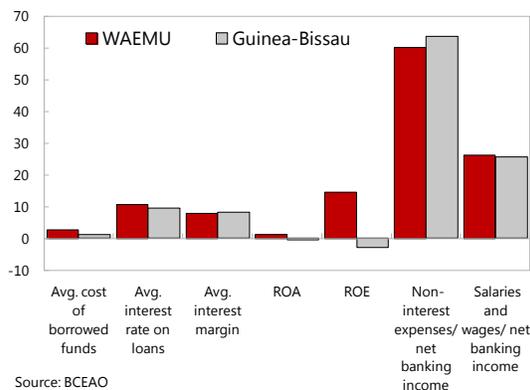
Indicators of Liquidity, June 2014



Source: BCEAO

Commercial banks' profitability is lower than in the WAEMU on average.

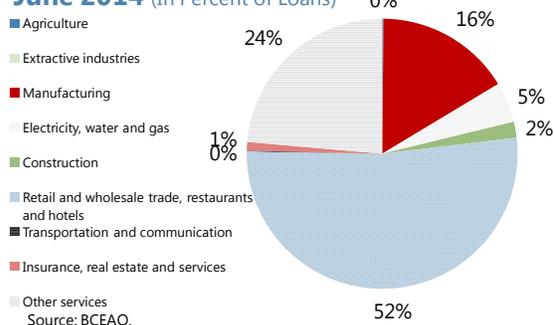
Indicators of Earnings and Profitability, Dec. 2013



Source: BCEAO

Loans are concentrated in a few sectors.

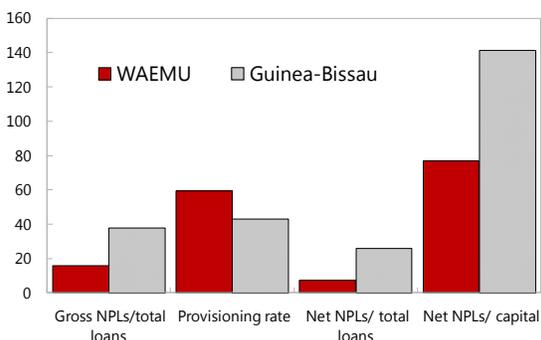
GNB: Sectoral Distribution of Loans, June 2014 (In Percent of Loans)



Source: BCEAO.

Ratios of non-performing loans are very high, ...

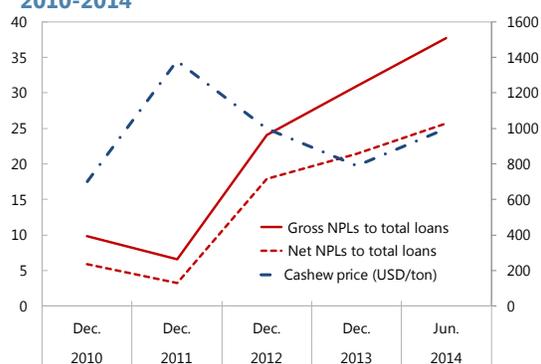
Non-Performing Loans, June 2014



Source: BCEAO

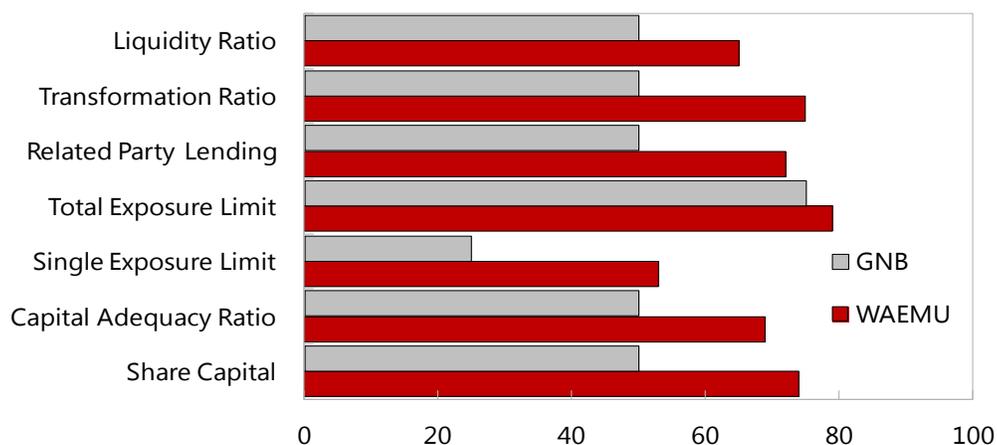
... in particular after the recent shock to the price of Guinea-Bissau's main product.

Non-Performing Loans and Cashew Prices, 2010-2014



Source: BCEAO

Figure 2. Compliance with Key Prudential Norms, June 2014
(In Percent of Banks)



Source: BCEAO.

Share Capital: minimum share capital of FCFA 5 billion. Capital Adequacy Ratio: minimum ratio of regulatory capital to risk-weighted assets of 8 percent. Single Exposure Limit: exposure to a single borrower or a group of connected borrowers not to exceed 75 percent of regulatory capital. Total Exposure Limit: sum of all risk-weighted exposures, each of which exceeds 25 percent of regulatory capital, not to exceed 8 times regulatory capital. Related Party Lending: Total lending to related parties not to exceed 20 percent of regulatory capital. Transformation ratio: Ratio of long-term funds (capital and long-term deposits and liabilities) to long-term uses of funds (investments in real estate assets, equities, and participations in addition to long-term loans and assets) at a minimum of 50 percent. Liquidity ratio: Ratio of short-term assets to short-term liabilities of minimum 75 percent.

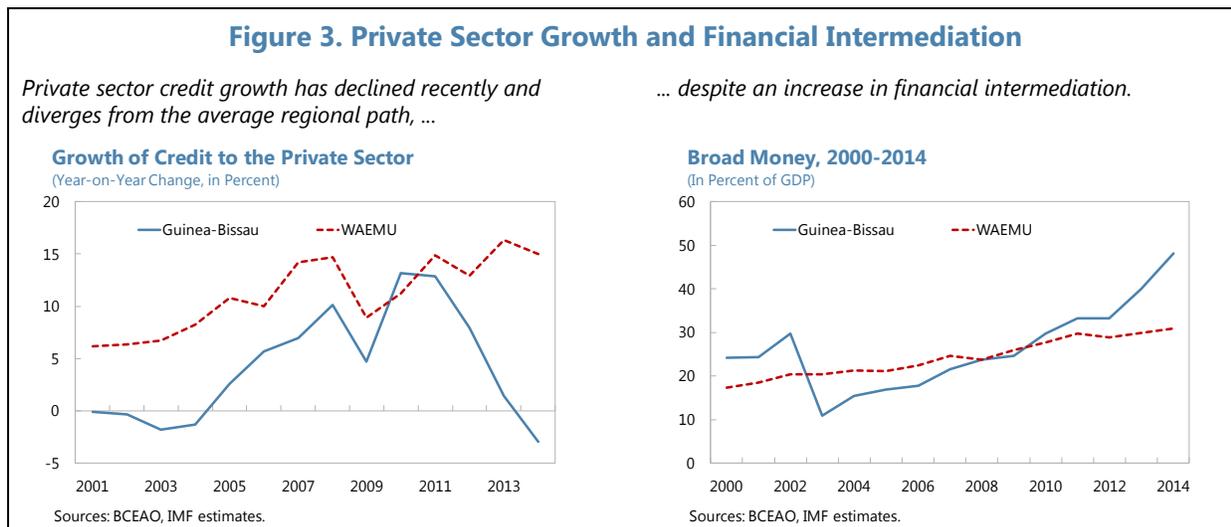
B. Private Sector Credit Depth

6. Private sector credit growth has slowed down recently, despite a substantial increase in intermediation (Figure 3). While growth of credit to the economy has been on an upward trend since 2004, it declined sharply in 2012, as a consequence of political uncertainty after the coup d'état and difficulties in the cashew sector due to the decline in the international cashew prices; credit growth turned negative in 2013 with the additional shock to cashew prices. Commercial banks perceive credit risk as very high, and consider investments into WAEMU government paper, or holding their liquidity with the BCEAO, as a safer option.

7. The ratio of private sector credit to GDP remains below the level implied by Guinea-Bissau's fundamentals (Figure 4). Following the methodology in Al Hussainy (2011) and Barajas et al. (2013), this note derives a benchmark ratio of private sector credit to GDP based on a number of structural factors in a panel of over 120 emerging and developing countries for the period from 1986 to 2013.³ The fitted values from these regressions serve as the private sector-to-GDP benchmark. For the case of Guinea-Bissau, this benchmark level is much higher than the actual level

³ It regresses the ratio of private sector credit-to-GDP on: (i) the log of GDP per capita and its square, (ii) the log of the population to proxy for market size, (iii) the log of population density to proxy for the ease of service provision, (iv) the log of the age dependency ratio to account for demographic trends and the related savings behavior, (v) an oil exporters dummy, and time dummies to control for global factors.

of private credit in percent of GDP, implying that financial depth is lagging behind the level implied the country's structural characteristics.



8. A number of policies could help Guinea-Bissau to increase private sector credit relative to the benchmark (Figure 5, Table 1). A regression of the financial gap (actual private sector credit-to-GDP minus its benchmark) on macroeconomic, institutional and policy variables helps identifying the drivers of the deviations from the benchmark for 2004-2013. Table 1 highlights the factors which help increasing private sector credit relative to the benchmark (see also IMF 2015b, inspired by Barajas et al. 2013). To assess the impact of feasible changes in the underlying factors, Figure 5 provides the implied reduction in the financial gap if, all other things equal, underlying factors were set to the level of the WAEMU country with the strongest record in each category. While causality is hard to establish in this exercise and the effects represent mostly associations, increasing trade openness, health (social) spending, FDI inflows and improved infrastructure to the top performing WAEMU country in the category could narrow the financial gap by 4½, 3, 1¾, and 1¼ percentage points, respectively.

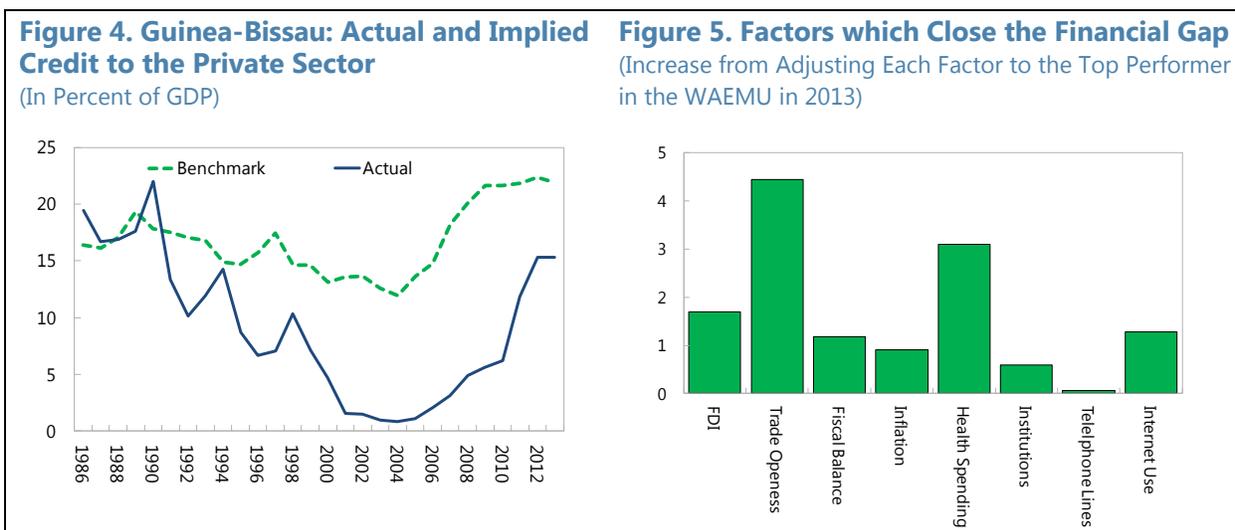


Table 1. Determinants of Financial Inclusiveness Gaps, 2004–13

	(1)	(2)	(3)	(4)	(5)
<i>Economic Environment</i>					
Growth	-0.004 *** (-3.08)				-0.004 *** (-3.04)
US Federal Funds Rate ¹	0.003 (0.69)				0.008 ** (2.17)
<i>External Stance</i>					
FDI/GDP		0.002 *** (2.92)			0.002 *** (3.17)
Trade Openess		0.209 *** (3.49)			0.217 *** (3.40)
Capital Controls		0.076 *** (3.96)			0.115 *** (5.73)
<i>Policies</i>					
Fiscal Balance (cycl. adjusted)/GDP			-0.185 ** (-2.16)		-0.247 ** (-2.52)
Inflation			-0.004 *** (-5.50)		-0.003 *** (-4.48)
FX Regime			0.007 (1.15)		
Health Spending/GDP			1.575 *** (3.61)		1.202 *** (2.57)
<i>Institutions and Infrastructure</i>					
Institutions (ICRG)				0.295 *** (4.38)	0.234 *** (3.14)
Telephone Lines				0.000 *** (11.44)	0.000 *** (-11.74)
Internet Use				0.001 ** (2.01)	0.001 * (1.75)
Credit Information Depth				-0.002 (-0.69)	
Constant	0.019 * (1.76)	-0.119 *** (-5.03)	-0.033 (-1.17)	-0.183 *** (-5.74)	-0.308 *** (-7.38)
Number of observations	1055	1055	1055	1055	1055
R-squared	0.01	0.04	0.04	0.09	0.18

¹Proxy for external environment.

Robust t-statistics in parentheses; significance levels at 10 percent (*), 5 percent (**), and 1 percent (***) levels, respectively.

C. Access to Financial Services

9. Financial access in Guinea-Bissau is low by most measures. Figure 6 compares different indicators of financial access in Guinea-Bissau against other WAEMU countries and groups of fast growing regional and Asian benchmark countries.⁴ It shows that:

- Provision of basic financial infrastructure, such as the density of ATMs and the number of bank branches in Guinea-Bissau is lower than in WAEMU on average—which itself lags behind other benchmark groups.
- The number of people with deposits at commercial banks is low. Only around 6 percent of adult Bissau-Guineans had deposits with a commercial bank in 2013, compared to around 13 percent in the WAEMU, and about 30 percent in fast growing African benchmark countries. However, the recent government initiative to make all public salary payments go through the banking system increases the number of adults with a bank account substantially and can lead to an increase in the number of depositors and also loans over time.
- Deposits in percent of GDP are also lower than in the WAEMU on average, with lower levels of deposits currently only observed in Niger. Amounting to 17 percent of GDP, outstanding loans from commercial banks are the lowest in the region.

10. The banking sector’s contribution to firms’ investment programs also appears limited (Figure 7). For the most recent year available (2006), enterprise surveys indicate that, while more than half of the firms in Guinea-Bissau possess a bank account, less than 5 percent of firms hold a loan or a line of credit, compared to less than 30 percent in most WAEMU countries. The majority of loans require high levels of collateral, and the acceptance of local assets as collateral is often problematic. Loans from banks constitute only a small fraction of firms’ investment financing, while internal funds appear to be the dominant source of financing investments. The most recent enterprise survey available confirms this picture, with the vast majority of respondents identifying access to finance as a major constraint for their businesses, in particular if they are active in manufacturing.

11. Lending rates by commercial banks remain high but in line with regional averages and relatively little variation between banks; better contract enforcement would help lower the rates (Figure 8). Average prime lending and maximum lending rates across banks in Guinea-Bissau stood at 9.5 percent and 14 percent, respectively, in December 2014, in line with the WAEMU average. However, the variation across banks in these rates has been, lower than in other WAEMU countries, likely owing to the limited number of banks in the country. Better enforcement of contracts, such as the possibility to faster recover collateral, could help lower these rates.

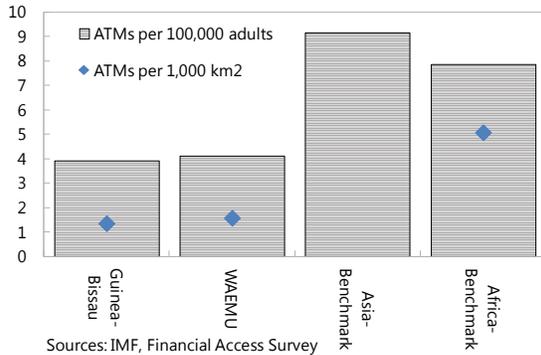
⁴ For most indicators, WAEMU averages or ranges are provided. More ambitious benchmarks include Ghana, Kenya, Lesotho, Rwanda, Tanzania, Uganda, and Zambia for Africa, and Bangladesh, Cambodia, India, Laos, Nepal, and Vietnam for Asia.

Figure 6. Access to Financial Services

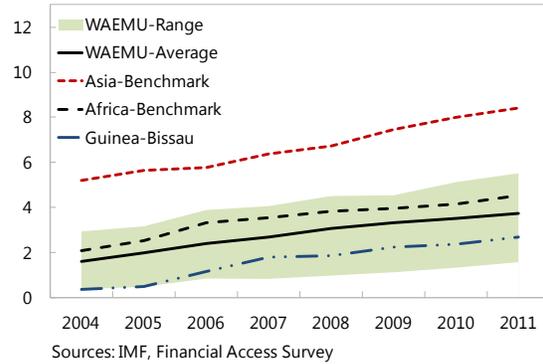
The degree of penetration of ATMs is in line with other WAEMU countries but low compared to more ambitious benchmarks.

Although increasing, the number of bank branches remains comparatively low.

Number of ATMs, 2013
(Per Thousand Square Kilometer and 100 Thousand Adults)



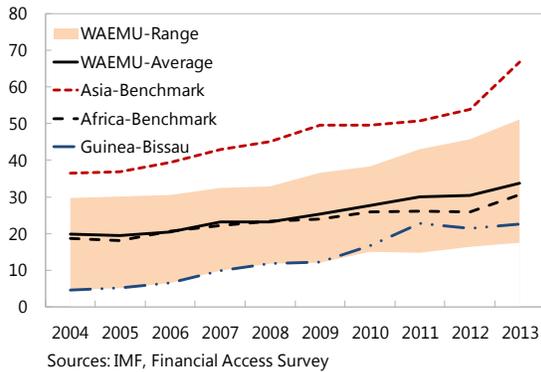
Commercial Bank Branches
(Per 100 Thousand Adults)



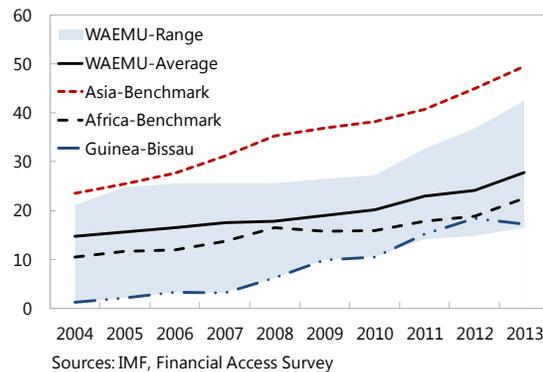
The share of the population with deposits at commercial banks has increased, but remains among the lowest in the region.

Outstanding loans are lower than in any other WAEMU country.

Outstanding Deposits with Commercial Banks
(In Percent of GDP)



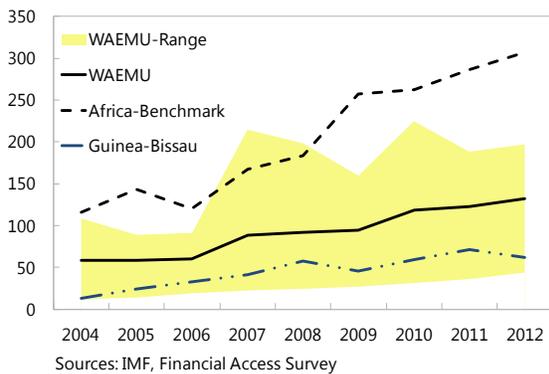
Outstanding Loans from Commercial Banks
(In Percent of GDP)



Only about 6 percent of adults are depositors with commercial banks, the lowest amongst the comparators, ...

... and the ratio is even lower for household depositors.

Depositors with Commercial Banks
(Per 1000 Adults)



Household Depositors with Commercial Banks
(Per Thousands of Adults)

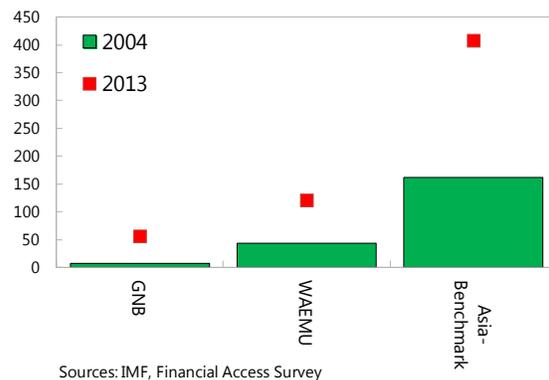
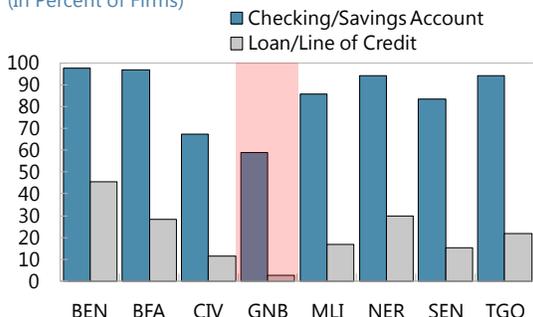


Figure 7. Access of Firms to Financial Services

While the majority of firms have an account at a bank, access to credit is negligible and the lowest in the region.

Firms with Accounts or Credit*

(In Percent of Firms)

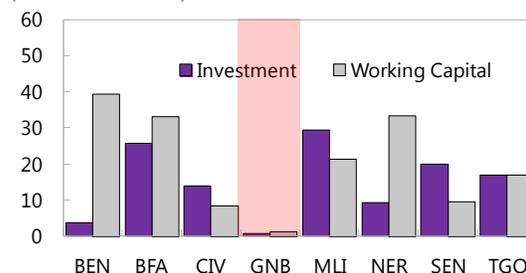


Source: World Bank Enterprise Surveys.
*GNB: 2006, other countries: latest available.

Almost no firms rely on banks to finance investment or working capital.

Firms Using Banks to Finance Investment and Working Capital*

(In Percent of Firms)

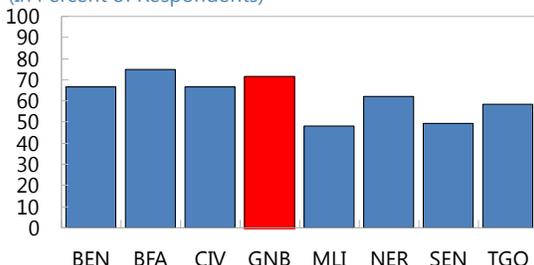


Source: World Bank Enterprise Surveys.
*GNB: 2006, other countries: latest available.

Firms identify access to finance as a major constraint...

Percent of Firms Identifying Access to Finance as Major Constraint*

(In Percent of Respondents)

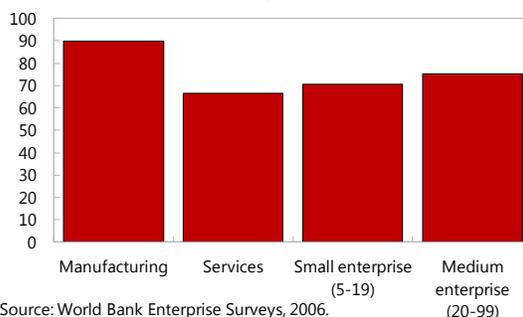


Source: World Bank Enterprise Surveys.
*GNB: 2006, other countries: latest available.

... especially in the manufacturing sector.

Guinea-Bissau: Percent of Firms Identifying Access to Finance as Major Constraint

(In Percent Respondents per Firm Type)

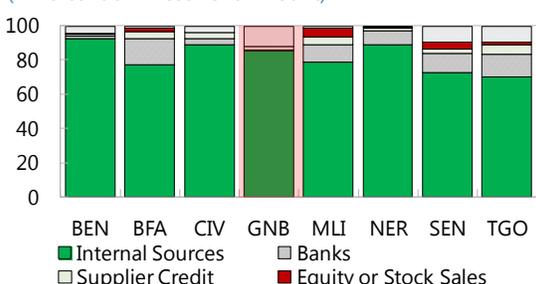


Source: World Bank Enterprise Surveys, 2006.

Comparable to other countries in the region, most investment financing is generated through internal sources in Guinea-Bissau, ...

Sources to Finance Investment*

(In Percent of Investment Amount)

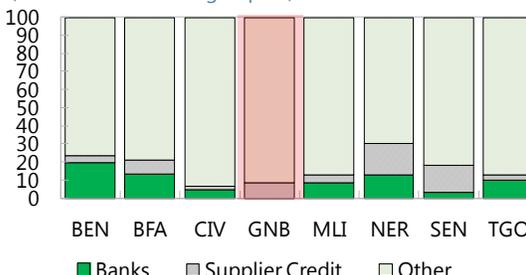


Source: World Bank Enterprise Surveys.
*GNB: 2006, other countries: latest available.

...while the amount of working capital contributed through banks was less than 1 percent.

Sources to Working Capital*

(In Percent of Working Capital)



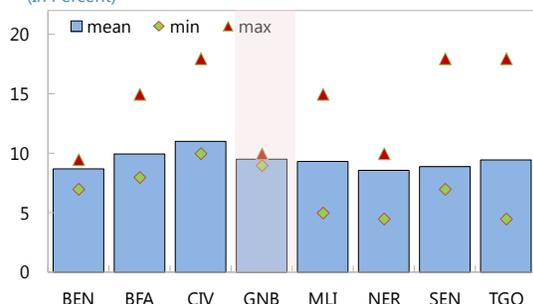
Source: World Bank Enterprise Surveys.
*GNB: 2006, other countries: latest available.

Figure 8. Cost of Credit in Guinea-Bissau

Average prime lending rates and maximum lending rates of banks are similar to those charged in other WAEMU countries. The variation of rates across banks is, however, lower in Guinea-Bissau than in the rest of the region.

Prime Lending Rates, December 2014*

(In Percent)

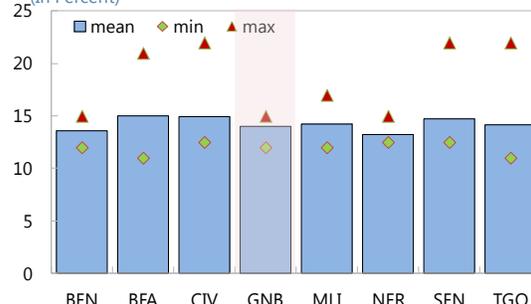


Source: BCEAO

*min and max refers to lowest and highest prime rate charged in the respective country at the bank level.

Maximum Lending Rates, December 2014*

(In Percent)



Source: BCEAO

*min and max refers to lowest and highest maximum rate charged in the respective country at the bank level.

12. In the short term, mobile payments services can help increase financial inclusion

(Figure 9, Boxes 1 and 2). While direct contact with financial infrastructure remains low, in particular for the most vulnerable parts of the populations, mobile phone penetration has increased rapidly in the last years. Taking into account that subscription rates should be discounted as subscribers possess on average two SIM-cards in Guinea-Bissau (World Bank, 2014b), recent numbers suggest that around 36 percent of the population possess at least one SIM card. Two mobile payment providers currently operate in Guinea-Bissau, with equal market shares. The development of mobile financial services could thus serve as a means to increase financial inclusiveness for the unbanked population. In addition, the magnitude of remittances in Guinea-Bissau suggests a substantial market for cross-border mobile payments. Box 1 summarizes the main pillars of the success of M-Pesa in Kenya, such as an inexpensive and flexible use of technology, a favorable macroeconomic environment, pre-existing banking infrastructure, support by the Central Bank, and risk management measures.

13. Box 2 points to the main means to mitigate risk related to mobile payments through the establishment of an oversight framework. These include minimum entry requirements into the sector, financial integrity controls, fund safeguarding, operational resiliency, and payment system stability.

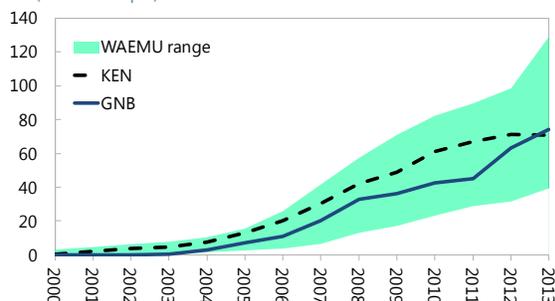
Figure 9. Potential for Mobile Payments

Mobile phone penetration has increased sharply in the last years...

...and the market for cross-border payments is significant.

Mobile Cellular Subscriptions

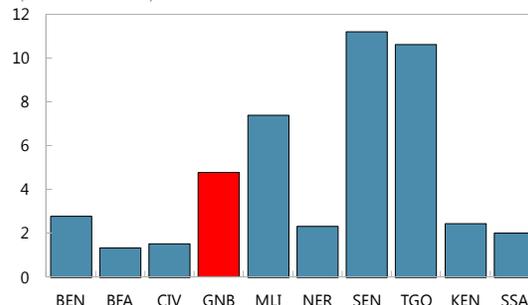
(Per 100 People)



Sources: World Development Indicators 2014

Personal Remittances, 2012 or Latest Available

(In Percent of GDP)



Source: World Bank, World Development Indicators.

Box 1. Expanding Mobile Payments: Kenya's M-PESA Experience

(based on IMF, 2012)

The fast spread of M-Pesa after its introduction in Kenya in 2007 has helped reduce transaction cost, facilitated personal transaction, and contributed to the use of services of financial intermediaries. Based on IMF (2012), this box summarizes the main determinants of M-Pesa's success as well as risk management issues.

Determinants of M-Pesa's success. While a rapid expansion in the use of mobile phones has contributed to the success of the developments of the sector, the following structural factors have likely made it possible:

- *Inexpensive and flexible use of technology.* Safaricom's widespread presence brought with it a large network of airtime resellers which became M-Pesa agents. Based on physical locations, agents are organized into groups with or without a centralized aggregator, such as a bank.
- *Macroeconomic environment.* Unusually large excess reserves held by commercial banks at the central bank led to the search for alternative lines of business.
- *Banking infrastructure.* The increasing availability of bank branches favored mobile-based transfers.
- *Government policies.* The Central Bank of Kenya (CBK) allowed Safaricom to operate M-Pesa as a parallel payments system, requiring only that customers' funds be deposited in a regulated financial institution, while Safaricom deposits and earned interest are placed in a non-profit trust account. The CBK also introduced limits on transaction sizes to mitigate money laundering risks.

Risk management issues. Advice for risk-prevention for M-Pesa by the Fund and actions taken included:

- *A formalization of M-Pesa operations in the National Payments Systems Bill* to provide a legal basis for M-Pesa operations and ensure customer protection, even if not linked to a deposit account.
- *Coverage of operational risks* through regulations addressing in detail the technological capabilities and control processes to ensure security.
- *Explicit incorporation of credit, liquidity and operational risks associated with M-Pesa transfers for microfinance institutions as well as consumer protection.*
- Close monitoring of risks related to cross-border mobile payments.

Box 2. Components of an Oversight Framework for Mobile Payments

(from IMF 2015b)

Mobile payment services promote financial inclusion, but they carry a number of risks which could be mitigated by an oversight framework with the following components:

- *Minimum entry requirement into the sector.* Entry requirements, such as minimum capital requirements for non-bank mobile service providers, can help reduce the risk of failure because operators will have to demonstrate that they have the financial capacity to supply mobile payment services. Such protection is particularly important given that mobile payment services are mostly addressed to the most vulnerable parts of the population.
- *Financial integrity controls.* Mobile payments may increase the complexity of payments and give rise to money laundering and financing of terrorism risks. Therefore, these services should be subject to adequate anti-money laundering/combating terrorism financing (AML/CFT) risk-based supervision by the WAEMU Banking Commission. Their providers should effectively implement AML/CFT preventive measures and report suspicious transactions to financial intelligence units.
- *Fund safeguarding.* As mobile payment services address mostly people at the lower end of the income distribution, they should include some form of guarantee or insurance to cover funds in case of failure of the mobile financial service provider. Such guarantee can be in the form of coverage by insurance companies or the inclusion of these services within the scope of deposit insurance schemes applicable in some countries. For Guinea-Bissau, this implies the need to develop insurance and to develop a deposit insurance scheme.
- *Operational resiliency.* Mobile payment services may run substantial operational risk, particularly when functioning under poor or limited infrastructure. Therefore, mobile payment providers' business continuity plans should be regularly tested for viability and effectiveness.
- *Payment system stability.* The high number of transactions connected with mobile payments may create settlement risk which might translate into both liquidity and credit risks potentially affecting financial stability. Therefore, mobile payment services, particularly those performed by non-banks, should be subject to a very robust clearance and settlement system leveraging on the system used for bank transactions.

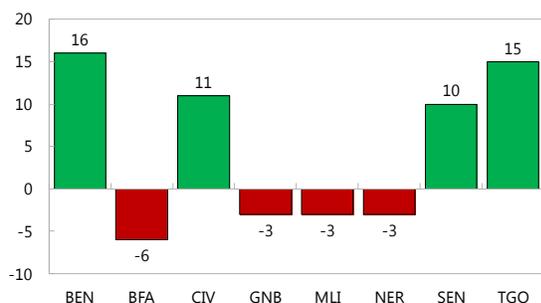
14. In the medium term, improvements in the business and legal environment would be necessary to improve access to financial services (Figure 10). The authorities need to address weak transparency, underdeveloped judicial and business environments, limited financial skills, and distortive taxation (such as the tax exemption of interest revenue on government paper, while other interest revenue is not tax exempt), suboptimal prudential regimes and regulatory forbearance, which remain the main obstacles to financial sector development. Lower collateral requirements stemming from a better legal environment and higher accounting standards could increase firms' access to financing and boost investment and GDP.

Figure 10. Doing Business

Guinea-Bissau's Doing Business rating has deteriorated between 2013 and 2014, ...

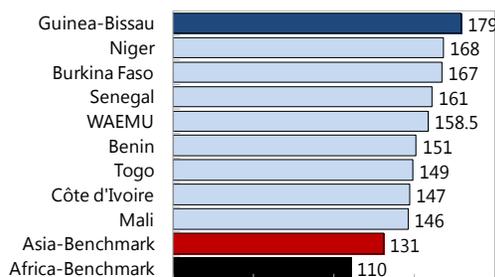
... ranking worst within WAEMU and with only 10 countries ranked as having a less favorable business environment.

Improvement in Doing Business Ranking
(In Number Ranks)



Sources: World Bank, Doing Business 2015.

Ease of Doing Business 2015
(Rank among 189 Economies)

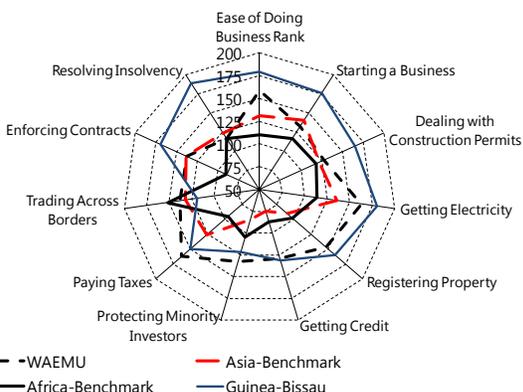


Sources: World Bank, Doing Business 2015

Contract enforcement, access to electricity, and starting a business seem to pose particular problems ...

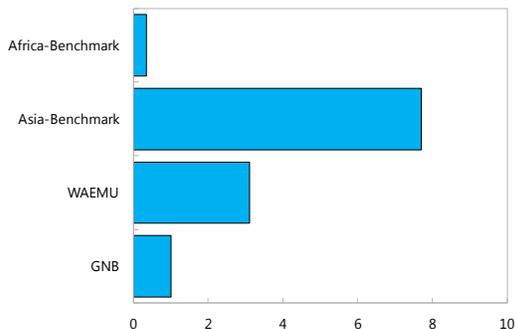
... and the coverage of credit registries is low.

Ease of Doing Business 2015
(Rank among 189 Economies)



Source: World Bank, Doing Business 2015

Credit Registry Coverage
(In Percent of Adults)



Sources: World Bank, Doing Business 2015.

D. Conclusions

15. Major challenges in Guinea-Bissau's financial sector require short- and medium attention. Guinea-Bissau's financial sector remains shallow, access to financial services in is low and the banking sector only marginally contributes to firms' investment programs. To address these challenges in the short-to medium term, action on several fronts will be required, in particular:

- **Stability.** Financial stability issues need to be addressed at the national and regional levels. For instance, compliance with and enforcement of key prudential ratios needs to improve on the regional level, and timely provision of data by the national BCEAO branches to the supervisory authorities will be essential in this regard.
- **Deepening.** Social spending and infrastructure investments will be essential to deepen the financial market.
- **Inclusion.** Stronger financial inclusion in the medium term will require major improvements in the business environment and financial literacy, while the use of mobile payment services could make financial services more accessible to a wider population in the short-term.

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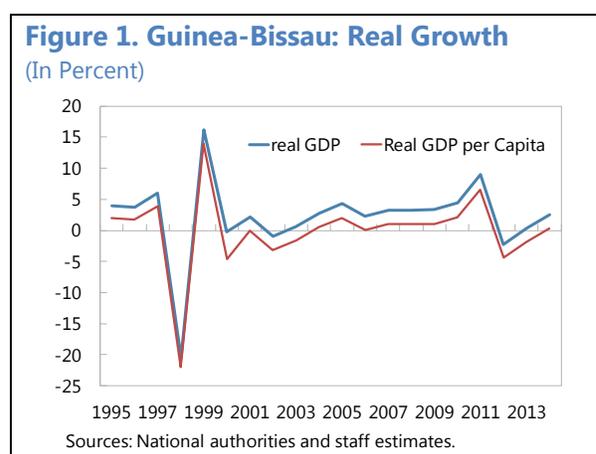
ECONOMIC DIVERSIFICATION¹

Growth in Guinea-Bissau has been disappointing and highly volatile. With exports and commercial bank lending being dominated by the cashew nut sector, Guinea-Bissau is highly vulnerable to exogenous shocks such as fluctuations in international cashew prices. The majority of the country's population is employed in low-productivity agriculture focused on cashew production which has superseded the production of rice. To reduce the economy's exposure to shocks, policies should focus on exploring "quick-wins" to economic diversification, such as reform or closure of the FUNPI, in the short term. To further diversify the economy in the medium to long term, policies could focus on easing main constraints in key areas such as infrastructure, education and the business climate. Given the importance of the primary sector for Guinea-Bissau and the country's biodiversity, economic policies could also target specific activities such as rice cultivation and mining, as envisaged under the government's Strategic Plan.

A. Growth, Volatility, and Productivity

1. Growth in Guinea-Bissau has been weak and highly volatile over the last decades

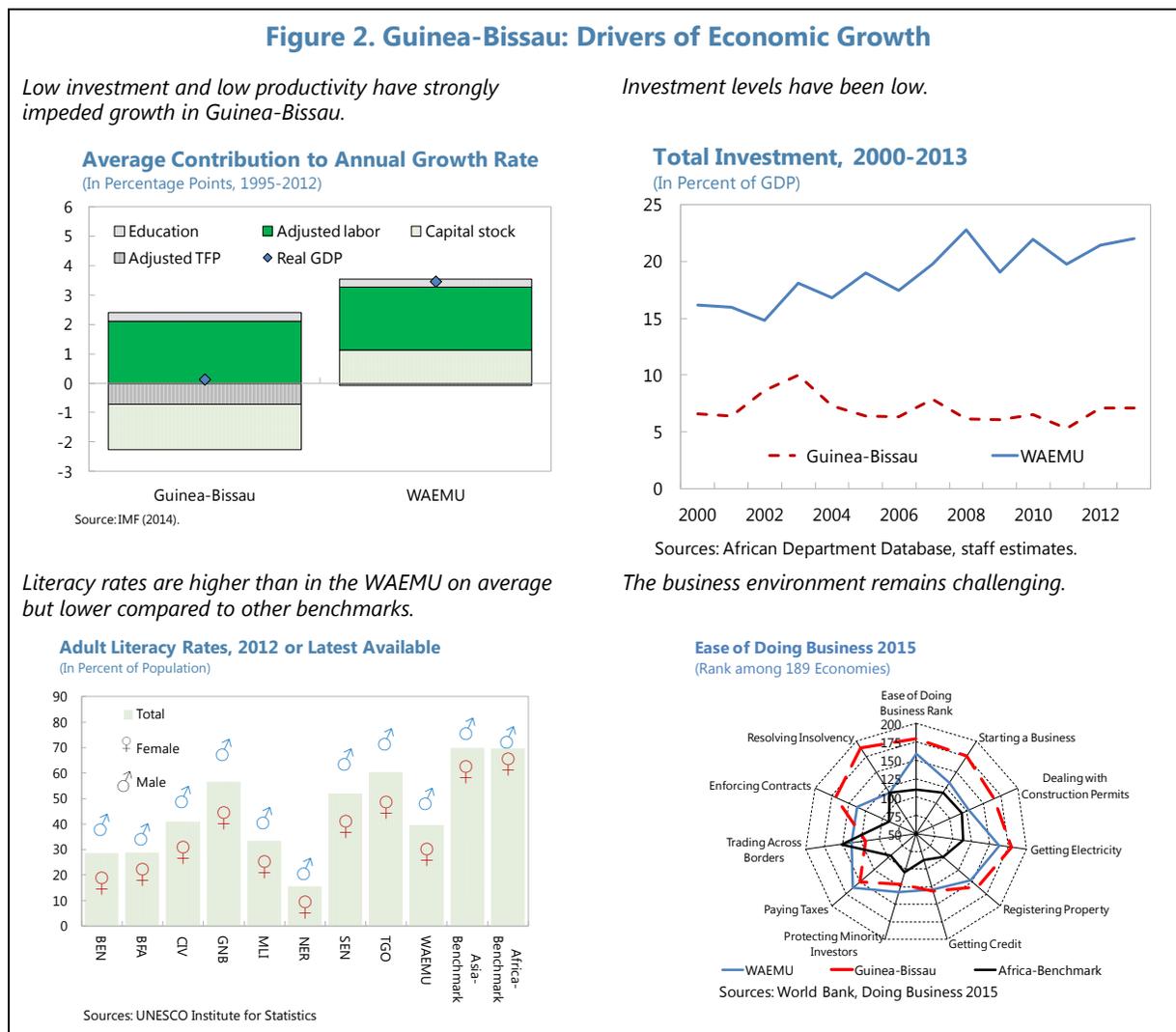
(Figure 1). From 1995 to 2014, real GDP has grown by an average of 2.3 percent per year, leaving the country's real GDP per capita at a lower level in 2014 than two decades ago. In addition, Guinea-Bissau's growth performance has been characterized by large volatility: Figure 1 highlights most notably the catastrophic effect of the civil war (1998-1999) but also other episodes of instability, such as through attempted or actual military coups (see Section 1 on the cost of fragility). The country remains vulnerable to exogenous shocks, such as fluctuations of international cashew prices, which added to the negative effect on growth from the 2012 coup.



2. Low physical and human capital accumulation and total factor productivity have posed major impediments to growth (Figure 2). In Figure 2, Guinea-Bissau's real growth rate is decomposed into the contributions capital, labor, education and total factor productivity. The factor 'gaps' from this simple exercise suggest that while improvements to education and labor force growth have on average contributed positively to growth, slow capital growth and total factor productivity have posed significant impediment to economic activity, as investment in percent of GDP has been less than half of that observed in other WAEMU countries. Guinea-Bissau performs

¹ Prepared by Monique Newiak. Part C of this section C heavily draws on recommendations in World Bank (2014) and IMF (2014a).

poorly in assessments of its business environment, with access to electricity, starting a business, and contract enforcement posing particular challenges. While measures of basic education, such the literacy rate, are comparable to those of other countries in the region, they are still low in absolute terms, and gender gap in literacy rates are much larger compared to Sub-Saharan and Asian countries which have achieved high growth rates in the past decades.

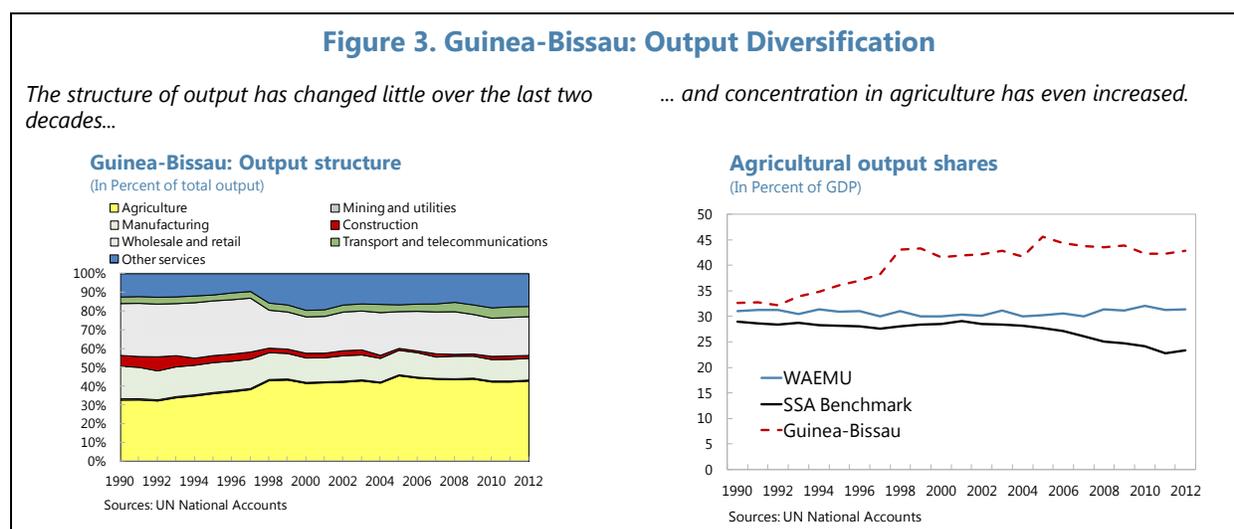


3. Policies to stimulate economic growth are required on multiple fronts. Significant investments to close the country’s capital and infrastructure gap will be needed to increase economic growth in the medium-term. Policies that target access and quality and inclusiveness of education could increase the contribution of human capital to growth. Reforms in public financial management (PFM) and governance would improve the efficiency of public and private investment, and improvements to the business environment, such as through stronger contract enforcement and more efficient and reliable electricity provision will be essential to raise productivity. The government’s emergency program to restore electricity through hiring a private company to install diesel-run generators has already shown a positive impact, but significant investments, as outlined

in the government’s Strategic Plan, and a restructuring of EAGB, the electricity and water company, will be key to improve the energy situation in the medium term.

B. Recent Trends in the Structure of Output and Exports

4. There has been relatively little evidence of structural change in Guinea-Bissau over time, in sharp contrast to fast growing Sub-Saharan African economies. Figure 3 highlights that structural transformation of Guinea-Bissau’s economy has been limited, if not backward oriented, with the agricultural sector growing more dominant, and the contribution of manufacturing, construction as well as wholesale and retail sectors having even declined slightly in the past two decades. The share of the tertiary sector, however, has increased somewhat since the mid-1990s. The rise of the share of the agricultural sector is in contrast to the trend observed for the WAEMU, where the share has remained stable, and even more so compared to the benchmark group of fast growing Sub-Saharan African countries in which the agricultural sector has on average become less dominant since 2000.



5. Export diversification has also declined, and Guinea-Bissau has grown more dependent on its dominant export partners (Figure 4). Export diversification, as defined in Box 1, has been constant over the last two decades in the WAEMU, and has increased strongly in fast growing Sub-Saharan African countries. In contrast, exports have also become more concentrated in Guinea-Bissau, with cashew exports accounting for 85 to 99 percent of exports each year. Most recent numbers on export diversification suggest that Guinea-Bissau has the least diversified export base in the WAEMU. Moreover, exports have been increasingly concentrated to India where the processing of cashew nuts takes place. This has been limiting the number of export partners for Guinea-Bissau, while diversification across export partners has increased in benchmark countries.

6. Relative export quality has generally declined and exports are highly concentrated on exports of relatively low quality (Figure 5). While the quality of Bissau-Guinean cashew nuts is high, the majority of nuts are exported unprocessed, with no relative improvements in export quality

over the last decade. The last chart in Figure 5 plots the export quality, as measured by the export's unit value adjusted for differences in production cost, distance to the trading partner, and the countries development (Box 1), for the largest sectors (2-digit SITC) in each WAEMU country. It suggests that, while some countries have succeeded in achieving a high product quality in at least one of their top export sectors, export concentration in many countries remains high in sectors of relatively low quality. This is particular the case in Guinea-Bissau, where exports are concentrated in products of relatively low quality.

7. Increasing diversification and quality upgrading could yield significant growth and stability gains. Based on estimated obtained in IMF (2014a) for low-income countries, increasing export diversification in Guinea-Bissau to levels observed in the WAEMU over the period 2001 to 2010 could have resulted in an increase in the average real growth rate for Guinea-Bissau by about 1 percentage points. In a thought-experiment which raises diversification in Guinea-Bissau to that of fast growing Sub-Saharan African or Asian countries, these gains are estimated at about 1½ percentage points.

Box 1. Export Diversification and Quality

(IMF 2014a and Henn et al., 2013)

Export product diversification is captured by the Theil index which can be decomposed into a “between” and a “within” sub-index:

$$\begin{aligned} \text{Theil Index} &= \frac{1}{N} \sum_i^N \frac{\text{Export Value}_i}{\text{Average Exp. Value}} \cdot \ln \frac{\text{Export Value}_i}{\text{Average Exp. Value}} \\ &= \text{Theil}_{\text{between}} + \text{Theil}_{\text{within}}. \end{aligned}$$

in which i is the product index and N the total number of products. The “between” Theil index captures the *extensive margin* of diversification, i.e. the number of products, while the “within” Theil index captures the *intensive margin* (product shares).

Export partner diversification. The Theil index is also available across export partners. In this case, i and N in the above relationship represent the export partner index and number of export partners, respectively.

Export quality is measured by the export's unit value adjusted for differences in production costs, relative distance to the trade partner, and the development of a country through the following relationship:

$$\text{Trade Price}_{mxt} = \alpha_0 + \alpha_1 \ln \text{unobservable quality}_{mxt} + \alpha_2 \ln p.c. \text{ income}_{mxt} + \alpha_3 \ln \text{Distance}_{mxt} + \text{Error}_{mxt},$$

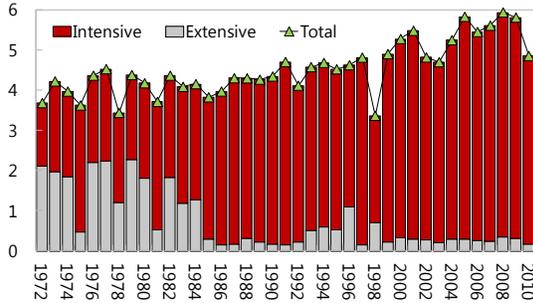
in which the sub-scripts m , x , and t denote importer, exporter and time period respectively.

Figure 4. Guinea-Bissau: Export Product and Partner Diversification

Exports have become more concentrated in the last decade.

Guinea-Bissau: Export Product Concentration

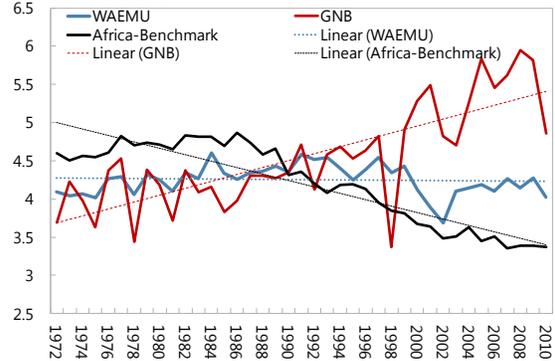
(Theil Index Decomposition, Lower Values=More Diversification)



... in contrast to fast growing African countries where exports became more diversified and relatively little action in the WAEMU on average.

Export Product Concentration

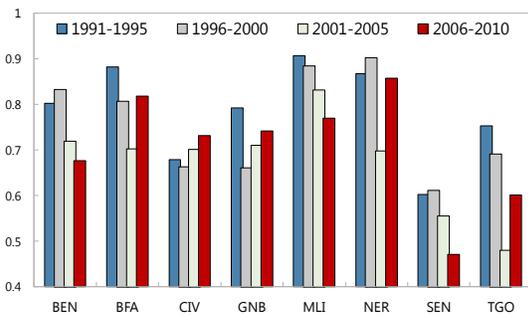
(Theil Index Decomposition, Lower Values=More Diversification)



The share of the major export products in total exports has increased in Guinea-Bissau over the last two decades...

Share of Three Major Exports in Total Exports, 1991-2010

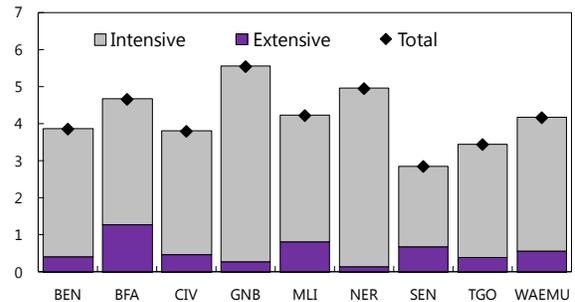
(Export Product Measured at 2-Digit SITC Level)



... and Guinea-Bissau is the least diversified economy in the WAEMU region.

Export Product Diversification, 2006-2010

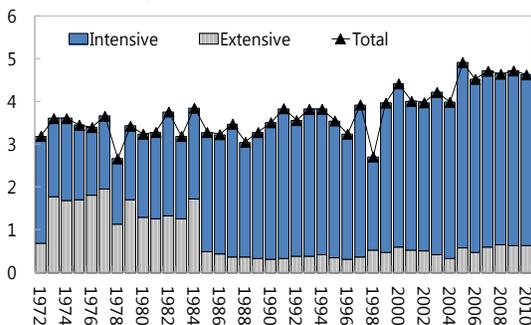
(Theil Index Decomposition, Lower Values=More Diversification)



Concentration across exports partners has also increased.

Guinea-Bissau: Export Partner Concentration

(Theil Index Decomposition, Lower Values=More Diversification)



... in contrast to the WAEMU and strongly growing African countries.

Export Partner Concentration

(Theil Index Decomposition, Lower Values=More Diversification)

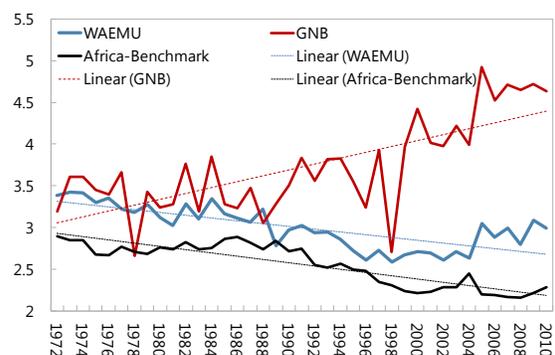


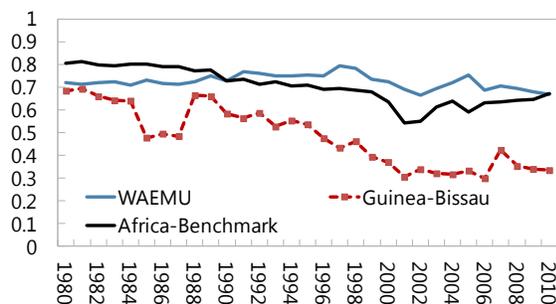
Figure 5. Guinea-Bissau: Export Quality

Relative agricultural quality has been lower than in the WAEMU and fast growing African countries...

... as has the quality of commodity exports for the periods observed.

Agricultural Quality

(1 = 90 Percentile of All Countries)

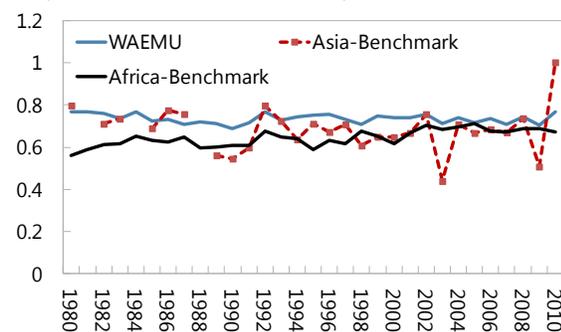


Source: IMF (2014a).

The quality of manufactured goods is generally not significantly worse than in the WAEMU on average.

Manufacturing Quality

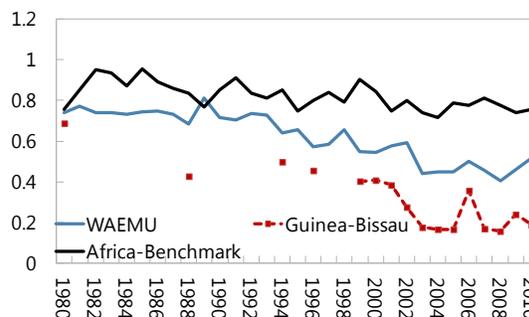
(1 = 90 Percentile of All Countries)



Source: Data from IMF (2014a).

Commodity Quality

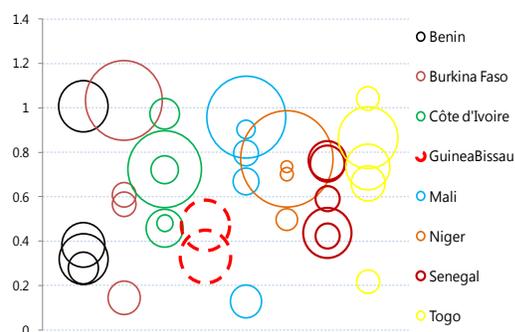
(1 = 90 Percentile of All Countries)



However, exports are dominated by products of relatively lower quality.

Export Quality for Five Largest Export Sectors

(1=90 Quality Percentile of All Countries; Size of Bubbles Proportional to Product Share)



C. Fostering Economic Diversification in Guinea-Bissau

8. To support diversification, policies should focus on addressing weaknesses that hinder entry into new lines of economic activity (Box 2; IMF 2014a). Weaknesses abound in Guinea-Bissau in particular in terms of the provision of infrastructure, the regulatory and institutional environment, the accumulation of human capital, and the provision of finance. Evidence from cross-country comparisons and individual case studies suggests that policies targeting these areas can be successful in fostering structural transformation and diversification, while the evidence is more mixed concerning the success of industry-focused and narrowly targeted measures (Box 2). However, given its dominance in terms of contributions to GDP and to employment and the potential for productivity and quality improvements, the agricultural sector, and in particular the cashew nut sector, warrants special attention in Guinea-Bissau. The following paragraphs therefore focus on the cashew sector.

Box 2. Reforms which Foster Structural Transformation

(based on IMF 2014a)

While there is no silver bullet of reform to foster structural transformation, the following general policies have emerged from successful country case studies and cross-country evidence (IMF 2014a, IMF 2013). Several of these policies may be addressed at both the national and regional levels:

- *Macroeconomic stability.* In Vietnam, Rwanda, Malaysia and Tanzania successful diversification has coincided with stronger macroeconomic policies and a greater degree of stability.
- *Market entry.* Reduced entry barriers can motivate entrepreneurs to expand their activities. In Vietnam collectivization was reversed which led to the emergence of a more diverse agricultural sector. In Rwanda a large divestment of state enterprises stimulated private sector activity, and in Tanzania, the dismantling of the state distribution system has positively affected the private sectors as well. The liberalization of the electricity market has been associated with higher degrees of structural transformation as well.
- *Education.* Education has been associated with higher levels diversification and export quality. In Vietnam, years of education increased by about 50 percent in just two decades. In Rwanda, education has been expanded through ninth grade for all students.
- *Institutions and the business environment.* Henn et al. (2013) report that a one standard deviation increase in institutional quality is associated with a 0.3 increase in quality upgrading. In Bangladesh, the removal of red tape has been associated with large investments in export processing zones.
- *Industrial policies.* The support of specific industries has shown mixed results. In Malaysia and Bangladesh, the targeting of specific industries has been successful, but the targeted sectors have become dominant, decreasing export diversification. In natural resource dominated economies, however, such targeting may help the economy to diversify.

“Quick-Wins” in the agricultural sector: Reforming the FUNPI

9. Background: The agribusiness development fund has failed to achieve its objectives (IMF, 2014c). The FUNPI (*Fundo para a Promoção da Industrialização dos Produtos Agrícolas*) was created in 2011 to promote agribusiness by easing financing constraints in a time when cashew exports from Guinea-Bissau were selling at historically high levels. It has been financed by surcharges of about US\$100 per ton of exports of raw cashew nuts that were additional to export taxes. However, the FUNPI faced major implementation problems:

- *The uncertainty over level of surcharge* every year resulted in inefficiencies, due to impeded possibility to plan the season, and speculative behavior in financial decisions, stockpiling and the timing of sales.
- *Divergence from use of funds for intended purpose.* FUNPI revenues have been partly used by the transitional government to ease a tight budget situation.
- *Increase in poverty.* Farmers, the majority of whom are poor, have been burdened most by the regressive FUNPI rate, as the tax was passed on directly to the farmers.
- *Smuggling.* The creation of the surcharge also increased smuggling and therefore losses in revenues, with the World Bank estimating losses in tax revenues and port/freight charges of US\$6.6 million (World Bank, 2014).

10. The authorities committed to an international audit of the FUNPI, the result from which would help restructure or close the Fund. The results from this audit, to be completed by September 2015 with the help of the World Bank, will lay the foundation for a new strategy to promote the cashew nut sector and to reduce poverty in rural areas. In particular, the elimination of the FUNPI tax would increase incomes for poor farmers and reduce poverty and extreme poverty by 2 and 3 percentage points, respectively. In combination with improved customs controls, it would reduce smuggling, thus boosting the government's revenue base. Development partners, such as the World Bank, are also willing to support the cashew sector through lending, guarantee funds and technical assistance.

Medium-term strategies²

11. While the expansion of other sectors, such as rice, mining, and tourism will be essential, developing a cashew processing industry can foster employment and structural transformation. According to recent World Bank estimates, approximately one job would be created for every three tons of processed cashew nuts, mainly in rural areas (World Bank, 2014). Expanding the cashew sector into processing would also result in less dependence on India as an export partner, and thus reduce the economy's vulnerability to shocks by diversifying export destinations. Given the current infrastructure gap, cashew processing could minimize pressure on roads by lowering transport volumes when exporting cashew kernel. It would imply higher value-added, thus stimulating growth and supporting the balance of payments.

10. Developing a cashew sector will require overcoming several challenges in financing, the business environment and infrastructure. The banking sector currently prefers to finance exports of raw cashew nuts rather than processed ones. It also sees lending to the private sector in general as risky as obtaining information on credit worthiness is very difficult and contract enforcement relatively weak (see Section 2). Stronger contract enforcement, for example via the opportunity to faster recovery of collateral, could go a long way in stimulating lending and lowering borrowing costs. Political stability risks and challenging business environment pose obstacles to foreign investment, making the security sector reform not only essential from an overall stability perspective but also for the financing of economic activity. Entrepreneurial capacity will need to be strengthened with a view of implementing best practices in the processing of cashew in the medium to long term (e.g. importing cashew nuts to employ cashew processing facilities in off-seasons as well). Large investments in roads will be necessary to ease transportation as there is currently hardly road access during the rainy season. Particular focus on attracting foreign investment to medium-size processing plants and establishing community-level processing facilities would help promote inclusiveness of the growth outcomes from these activities.

² This section has heavily benefited from the analysis in World Bank (2014).

D. Conclusions

11. Short and medium-term policies to diversify Guinea-Bissau's economy could help the country break with a history of low and volatile growth. With exports and commercial bank lending being dominated by the cashew nut sector, Guinea-Bissau is highly exposed to exogenous shocks such as fluctuations in international cashew prices. In the short term, to reduce the economies exposure to shocks, policies should focus on exploring "quick-wins" to economic diversification, such as reform or closure of the FUNPI. To further diversify the economy in the medium to long term, policies could focus on easing main constraints in key areas such as infrastructure, education and the business climate. Given the importance of the primary sector for Guinea-Bissau and the country's biodiversity, economic policies could also target specific activities such as rice cultivation and mining, as envisaged under the government's Strategic Plan.

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