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COUNTRY FOCUS: Georgia's oil and gas transit fees

Over the next couple of years, two new pipelines in the Caspian basin will start carrying oil and gas from Azerbaijan through Georgia to Turkey and the Mediterranean. What will this mean for Georgia? The transit fees for oil and gas are expected to bolster revenues, but just how much revenue can be expected and whether this additional revenue justifies the creation of a special natural resource fund are the subject of a recent IMF Working Paper.

Riza Ozel/AFP

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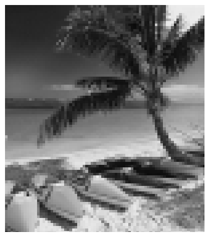
COUNTRY FOCUS: Mauritius must adapt

Over the past 25 years, Mauritius has bucked low growth trends in its region, built a vibrant economy, and nearly tripled per capita incomes. In recent years, however, two major sources of export income and jobs—sugar and textiles—have been hit by the loss or reduction of preferential trade arrangements. Now, this resilient economy must step up productivity, develop new niche products, and further diversify to ensure continued economic success.



Petri/Colorise/ZUMA Press

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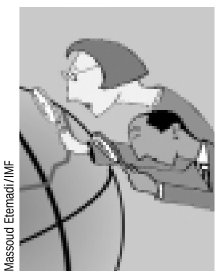
POLICY: More effective IMF surveillance

Surveillance—the ongoing dialogue that the IMF has with its member countries on their economic policies—lies at the heart of the organization's efforts to ensure a stable international monetary system and prevent crises. In its 2004 biennial review of surveillance, the IMF's Executive Board identified six priority areas in which effectiveness could be strengthened, including sharpening the focus of surveillance and deepening attention to exchange rate issues. Lynn Aylward (IMF Policy Development and Review Department) looks at the progress to date.



Massoud Etemadi/IMF

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FORUM: Why measuring governance matters

There is no denying that governance is a hot topic. Increasingly, donors and investors now base their decisions on which countries to give aid to and invest in on perceptions of governance. But is the emphasis on governance warranted? Is there a clearly proven link between governance and growth? And can governance be measured in any meaningful way? Aart Kraay, one of the pioneers of the World Bank's governance database, answered these and other questions at a recent IMF Institute seminar.

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What's on

August

4–5 IMF Managing Director Rodrigo de Rato to visit Ukraine

22–26 IMF–Singapore Regional Training Institute seminar, "Creditor Rights in Emerging Economies," Singapore

24–September 2 APEC Small and Medium Enterprise Ministerial, Daegu, Republic of Korea

September

6–7 IMF high-level seminar, "Financial Stability—Central Banking and Supervisory Challenges," Washington, D.C.

6–9 APEC Finance Ministers Meeting, Jeju, Republic of Korea

8 IMF Economic Forum, "IMF Conditionality: Good, Bad, or Ugly?" Washington, D.C.

14–16 High-level plenary meeting, UN General Assembly, to review progress on UN Millennium Declaration commitments, New York

19–23 IMF seminar for parliamentarians from Bosnia and Herzegovina, Croatia, Macedonia, and Serbia and Montenegro, Joint Vienna Institute, Vienna, Austria

22–23 Global Forum on Tax Treaties and Transfer Pricing, OECD Center for Tax Policy and Administration, Paris

24–25 IMF and World Bank Annual Meetings, Washington, D.C.

26–30 International Atomic Energy Agency General Conference, Vienna, Austria

27–30 Meeting of the International Task Force on the Harmonization of Public Sector Accounting, IMF, Washington, D.C.

October

19 IMF Book Forum, Pietra Rivoli, *Travels of a T-Shirt in the Global Economy: An Economist Examines the Markets, Power, and Politics of World Trade*, Washington, D.C.

November

3–4 IMF Jacques Polak Sixth Annual Research Conference, Washington, D.C.

4–5 Fourth Summit of the Americas, Mar del Plata, Argentina

16–18 World Summit on the Information Society, Tunis, Tunisia

27–29 World Economic Forum, India Economic Summit, New Delhi, India

December

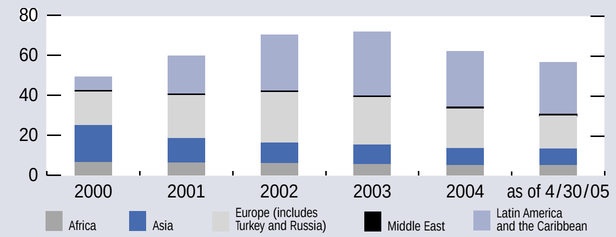
13–18 The Sixth WTO Ministerial Conference, Hong Kong SAR

IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*.

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region
(billion SDRs, end of period)

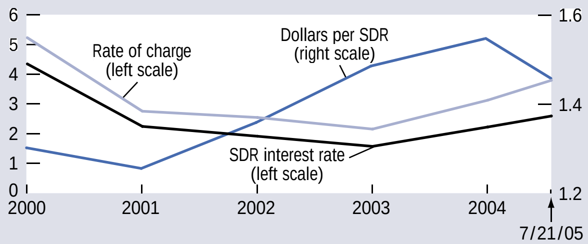


Major currencies, rates per SDR
(end of period)

	July 2005	Year ago
Euro	1.205	1.207
Japanese yen	162.890	161.329
U.K. pound	0.832	0.797
U.S. dollar	1.445	1.468

IMF available resources
(one-year forward commitment capacity, billion SDRs)

Related rates
SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR
(percent, end of period) (dollars per SDR, end of period)



Note on IMF Special Drawing Rights
Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

Sustained strong growth in Belarus requires market-oriented reforms, policy tightening

In 2004, Belarus experienced strong economic growth, supported by a favorable external environment and policies aimed at raising incomes and credit, the IMF said in its annual economic review. Inflation was halved during 2004 and slowed further to 11 percent in April 2005, aided by a balanced budget, exchange rate stability, and continued remonetization on the back of rising trust in banks and the national currency. Inflationary financing of the budget from the central bank was discontinued, and budgetary consolidation progressed further. International reserves rose, government debt is low, and the end-2004 surge in the current account deficit was largely reversed in early 2005.

On the downside, market-oriented structural reforms have stalled, and the business environment is not conducive to private—including foreign—investment. Privatization has largely ground to a halt, and the private sector's share of GDP remains low at around 25 percent. Given the economy's current momentum, significant growth is likely in 2005, but its long-term prospects are uncertain in the absence of wide-ranging structural reforms and a phase-out of pervasive quasi-fiscal activities, notably rapid centrally mandated wage increases and directed lending (which has contributed to escalating liquidity problems in key banks and necessitated further government recapitalizations).

The IMF's Executive Board welcomed the country's strong growth, reduced inflation, and markedly improved poverty indicators. It cautioned, however, that the massive benefits reaped from Russian energy import pricing are likely to fade. It therefore urged the authorities to take advantage of the current favorable external environment and the economy's momentum to tighten macroeconomic policies and launch wide-ranging reforms to facilitate sustained private-sector-led growth. It underscored the need to accelerate the consolidation of quasi-fiscal activities into the budget and reduce their magnitude to safeguard the budget balance. While the nominal exchange rate has played a useful anchoring role from early 2004, the Board saw a need to retain a measure of exchange rate flexibility to safeguard against excessive real appreciation and help deal with exogenous shocks. In addition, the central bank will need to make low inflation its primary objective—a step that would entail granting the central bank full operational autonomy—and to continue raising the level of foreign reserves. ■

Republic of Belarus	2001	2002	2003	2004
	(annual percent change[1])			
Real GDP	4.7	5.0	7.0	11.0
CPI (end-of-period)	46.1	34.8	25.4	14.4
Real average monthly wage (1996=100)	213.9	231.9	238.7	279.0
Gross international reserves (months of imports of goods and services)	0.5	0.6	0.5	0.6
Medium- and long-term debt (percent of GDP)	9.2	9.8	8.1	5.9
Short-term debt (percent of GDP)	10.4	11.0	10.8	12.8
Exchange rate (rubles per U.S. dollar[2])	1,383.0	1,784.0	2,052.0	2,160.0

[1]Unless otherwise indicated.
[2]Period average.
Data: Belarus authorities and IMF staff estimates.

Egypt's policies take a pro-reform turn, addressing main challenges

Egypt's economic policies sharply changed direction in 2004 following the appointment of a pro-reform cabinet led by Prime Minister Ahmed Nazif. The new cabinet moved quickly to put in place a number of key trade, foreign exchange, and tax policy reforms. The government also announced plans to restructure the financial sector and privatize most state enterprises, while taking steps to modernize fiscal accounts and strengthen monetary policy.

In concluding the IMF's annual review of the economy in May 2005, the IMF Executive Board commended the Egyptian authorities for the clear change in the direction of economic policies and progress made thus far. The pace of economic recovery picked up in 2004, with real GDP increasing by 4.8 percent in the first half of fiscal year 2004/05 (July–December 2004), compared with the same period a year earlier. Growth was driven largely by strong external demand and underpinned by a moderate revival in consumption and improved investor confidence. Egypt's current account surplus expanded to 4.4 percent of GDP in the fiscal year ending June 30, 2004 and is estimated to be slightly higher for fiscal year 2004/05. External conditions are expected to remain favorable, and the recovery is likely to strengthen during fiscal year 2005/06.

The IMF Board noted, however, that considerable challenges lie ahead to complete Egypt's transformation into a dynamic, private sector-driven economy. Output growth remains below the threshold needed to absorb labor force growth, while government borrowing and debt remain high. The IMF Board encouraged the authorities to maintain the pace of structural reform in the financial, trade, and privatization areas while pursuing decisive fiscal consolidation and strengthening the monetary policy framework to help boost private investment and growth. ■

Egypt	2001	2002	2003	2004[1]
	(annual percent change)			
Real GDP	3.2	3.1	4.1	4.8
Consumer price inflation (end-of-period)	2.7	4.0	11.7	9.0
	(billions of U.S. dollars)			
Exports of goods and services	15.8	18.0	22.9	28.9
Total oil and gas exports	2.4	3.2	3.9	5.7
	(percent of GDP)			
Current account balance	0.7	2.4	4.4	4.5
General government balance	–2.5	–2.4	–2.5	–3.1
General government borrowing requirement	7.9	7.1	6.6	7.1
Net public debt	61.9	65.9	65.7	63.7

[1]Egypt's fiscal year ends June 30. Figures for 2004/05 are staff estimates.
Data: Egyptian authorities and IMF staff estimates.

In the news

Samoa outpaces comparators but needs to consolidate gains to boost growth prospects

Samoa has become one of the best-managed economies in the Pacific Island region over the past decade, the IMF said in its recent economic review. The economy registered solid growth, low inflation, and improved public finances and international reserve levels, and outperformed comparator countries within and outside the region. Samoa also made progress toward achieving the Millennium Development Goals.

Political stability, close consultation with stakeholders, and extensive efforts to foster a broad consensus for reform have been integral to the country's success. Nevertheless, economic performance weakened in recent years, the export base continues to be narrow, and the economy remains vulnerable to external shocks. Substantial reforms are needed to consolidate gains and boost Samoa's long-term growth prospects.

The IMF's Executive Board commended the authorities for their good macroeconomic management and continued efforts to reform the civil service, liberalize the telecommunications sector, and strengthen banking supervision and its framework for anti-money laundering and combating the financing of terrorism. Also welcomed was the recent pickup in growth and the decline in inflation following a significant increase in 2004 that largely reflected the impact of Cyclone Heta on food prices, and the authorities' intention to tighten monetary policy in view of the potential balance of payments pressures that could arise from the large budget deficit in 2005/06.

Over the medium term, Samoa's economic prospects remain favorable, the Board said, if it can sustain macroeconomic stability and facilitate private sector development—notably through deeper reforms of state-owned enterprises and land reform. Fiscal discipline will be essential to further reducing public indebtedness and enhancing Samoa's flexibility to respond to external shocks. The Board encouraged the authorities to strengthen tax administration and better rationalize and reorient spending toward education, health care, and infrastructure. ■

Samoa	2001/02	2002/03	2003/04	2004/05	2005/06
				Projections	
		(12-month percent change)			
Real GDP	4.4	1.8	3.5	3.0	3.0
Change in CPI (end period)	9.8	1.6	17.2	–2.9	2.0
		(percent of GDP)			
Central government budget, overall balance	–2.1	–0.6	–0.9	–0.9	–4.0[1]
		(months of next year's total imports)			
Official reserves	4.2	3.4	3.6	3.9	4.0

[1]Based on 2005/06 budget.

Data: Samoan authorities and IMF staff estimates.

Fiscal tightening needed to help Bahamanian economy reach growth potential

After two years of low growth stemming from a drop off in tourism, the Bahamian economy rebounded in 2003–04. According to the IMF's economic review, Bahamas' balance of payments strengthened markedly in 2004, and net international reserves rose substantially. A widening of the trade deficit, owing mainly to a higher oil import bill, was offset by an expansion of tourism receipts and reinsurance-related inflows following two hurricanes. The recovery also led to a decline in the unemployment rate in 2004, to just over 10 percent.

Low inflation, a sound banking system, and generally prudent fiscal policies have set the stage for private-sector-led growth, supporting a broadly favorable medium-term outlook. Nevertheless, challenges remain. The government deficit rose sharply during the economic slowdown of 2001–02 and remained above 3 percent of GDP through fiscal year 2003/04 and above the authorities' 2½ percent of GDP target for 2003/04. Although current outlays on nonwage goods and services and capital expenditures were compressed, tax revenues remained depressed, and public sector wages continued to rise. The government deficit in 2004/05 is estimated to have declined to 2½ percent of GDP, but the debt-to-GDP ratio continued to rise, to about 37 percent.

The IMF's Executive Board noted the need for a stronger fiscal stance to place the debt-to-GDP ratio on a downward path. Directors welcomed the authorities' intention to lower the government debt-to-GDP ratio to 30 percent over the medium term. To this end, a comprehensive tax reform—entailing the introduction of a value-added-tax or sales tax and a lowering of import tariffs—would help sustain revenues and reduce vulnerability to external shocks, while also facilitating the possible accession to the World Trade Organization. On the expenditure side, the Board emphasized the importance of containing public sector wages increases to maintain international competitiveness, especially in the tourism industry. Fiscal strengthening, it added, should also be supported by structural policies and private infrastructure investment, which in turn would help diversify the economy. ■

The Bahamas	2001	2002	2003	Prel. 2004	Proj. 2005
		(12-month percent change)			
Real GDP	0.8	1.4	1.9	3.0	3.5
Consumer price index (annual average)	2.0	2.2	3.0	0.9	1.8
	(percent of GDP at market prices, unless otherwise indicated)				
Central government overall balance[1]	–0.4	–3.2	–3.4	–3.2	–2.6
Central government debt (end-June)	30.8	32.4	34.4	36.0	37.0
Net international reserves	312	373	484	668	642

[1]Corresponds to the fiscal year ending June 30.

Data: The Central Bank of The Bahamas; The Bahamas Department of Statistics; Ministry of Tourism; Ministry of Finance; and IMF staff estimates and projections.

For more information, refer to IMF Public Information Notices No. 05/81 (Belarus), No. 05/72 (Egypt), No. 05/86 (The Bahamas), and No. 05/80 (Samoa) on the IMF's website (*www.imf.org*).

HIPC debt relief (status as of July 21, 2005)

IMF member	Decision point	Completion point	Amount committed	Amount disbursed[1]
			(million SDRs)	
Heavily Indebted Poor Countries (HIPC) Initiative				
Under original 1996 Initiative				
Bolivia	September 1997	September 1998	21.2	21.2
Burkina Faso	September 1997	July 2000	16.3	16.3
Côte d'Ivoire	March 1998	—	16.7[2]	—
Guyana	December 1997	May 1999	25.6	25.6
Mali	September 1998	September 2000	10.8	10.8
Mozambique	April 1998	June 1999	93.2	93.2
Uganda	April 1997	April 1998	51.5	51.5
Total original HIPC			**235.3**	**218.6**
Under the 1999 Enhanced HIPC Initiative				
Benin	July 2000	March 2003	18.4	20.1
Bolivia	February 2000	June 2001	41.1	44.2
Burkina Faso	July 2000	April 2002	27.7	29.7
Cameroon	October 2000	Floating	28.5	5.5
Chad	May 2001	Floating	14.3	8.6
Congo, Democratic Republic of	July 2003	Floating	228.3[3]	2.3
Ethiopia	November 2001	April 2004	45.1	46.7
Gambia, The	December 2000	Floating	1.8	0.1
Ghana	February 2002	July 2004	90.1	94.3
Guinea	December 2000	Floating	24.2	5.2
Guinea-Bissau	December 2000	Floating	9.2	0.5
Guyana	November 2000	December 2003	31.1	34.0
Honduras	June 2000	April 2005	22.7	26.4
Madagascar	December 2000	October 2004	14.7	16.4
Malawi	December 2000	Floating	23.1	6.9
Mali	September 2000	March 2003	34.7	38.5
Mauritania	February 2000	June 2002	34.8	38.4
Mozambique	April 2000	September 2001	13.7	14.8
Nicaragua	December 2000	January 2004	63.5	71.2
Niger	December 2000	April 2004	31.2	34.0
Rwanda	December 2000	April 2005	33.8[4]	37.5
São Tomé and Príncipe	December 2000	Floating	—	—
Senegal	June 2000	April 2004	33.8	38.4
Sierra Leone	March 2002	Floating	98.5	66.0
Tanzania	April 2000	November 2001	89.0	96.4
Uganda	February 2000	May 2000	68.1	70.2
Zambia	December 2000	April 2005	468.8	508.3
Total Enhanced HIPC			**1,590.3**	**1,354.4**
Combined total			**1,825.5**	**1,573.0**

Definitions

Decision point: Point at which the IMF decides whether a member qualifies for assistance under the HIPC Initiative (normally at the end of the initial three-year performance period) and decides on the amount of assistance to be committed.

Completion point: Point at which the country receives the bulk of its assistance under the HIPC Initiative, without any further policy conditions. Under the Enhanced HIPC Initiative, the timing of the completion point is linked to the implementation of pre-agreed key structural reforms (that is, floating completion point).

[1]Includes interest on amounts committed under the Enhanced HIPC Initiative.

[2]Equivalent to the committed amount of $22.5 million at decision point exchange rates for March 17, 1998.

[3]Amount committed is equivalent to the remaining balance of the total IMF HIPC assistance of SDR 337.9 million, after deducting SDR 109.6 million representing the concessional element associated with the disbursement of a loan under the Poverty Reduction and Growth Facility following the Democratic Republic of the Congo's clearance of arrears to the IMF on June 12, 2002.

[4]Excludes commitment of additional enhanced HIPC assistance of SDR 12.98 million subject to receipt of satisfactory financing assurances from other creditors.

Data: IMF Finance Department.

In the pipeline: Georgia's oil and gas transit revenues

Over the next few years, Georgia—situated between the Black Sea on the West and the Caspian Sea on the East—will become an increasingly important transit point for oil and natural gas exports from its neighbor, Azerbaijan, and from the Caspian Sea to Europe. Two new pipelines under construction hold out the promise of increased revenues from transit fees. How lucrative will this be for Georgia? In an IMF Working Paper, Andreas Billmeier, Jonathan Dunn, and Bert van Selm of the IMF's Middle East and Central Asia, and Asia and Pacific Departments make some revenue projections and suggest policies that could help to ensure effective use of these revenues.

Source: British Petroleum. The IMF assumes no responsibility for the accuracy of the map.

Azerbaijan today uses two pipelines to export its oil (see map). One takes the western route to the Georgian Black Sea coast; the other a northern route through Russia. The western route is the preferred one for taking Azeri crude oil to world markets; it is much shorter, and, as a result, has much lower transport costs. In addition, Azeri light crude using the Russian pipeline system loses value when mixed with Siberian crude.

The western and northern routes, however, share a common disadvantage. They use Black Sea ports that require passing through crowded Turkish straits to reach the Mediterranean. With oil exports from the former Soviet Union rising rapidly, the traffic bottleneck at the Bosporus and the Dardanelles has become increasingly problematic, prompting governments and oil companies with a stake in Azeri oil exports to build a new pipeline that will take Azerbaijan's crude oil directly to the Mediterranean. In 1995, two groups of companies—led by British Petroleum—began work on this pipeline, along with another that will carry gas from Azerbaijan to Turkey through Georgia.

The Baku-Tbilisi-Ceyhan (BTC) pipeline, expected to become operational by the end of 2005, traverses 1,760 kilometers (1,094 miles) of often remote and challenging terrain and has the capacity to transport up to 1 million barrels of crude oil a day from a cluster of sources in the Caspian Sea, known as the Azeri-Chirag-Gunashli field.

The South Caucasus Pipeline (SCP), expected to be operational by the end of 2007, will carry gas from the Shah Deniz field (one of the biggest gas fields in the world, off the Azerbaijan shore) to Azerbaijan, Georgia, Turkey, and other countries. It will follow the same route as the BTC crude oil pipeline through Azerbaijan and Georgia to Turkey, where it will then link to the Turkish gas distribution system. Spanning 690 kilometers (429 miles), it can carry up to 7 billion cubic meters of gas a year upon completion, with the possibility of doubling this capacity in the future.

A revenue boon?

How much can Georgia expect to earn from the transport of oil and gas via the BTC and the SCP? According to the authors' assumptions (see box, next page), Georgia is projected to receive around 1 percent of GDP in additional revenues (around $80 million) a year over the medium term. While these transit revenues would make a significant contribution to the government's resource envelope, given the country's relatively low tax revenue (the 2004 tax-to-GDP ratio amounts to 18 percent), they are not of the same order of magnitude as revenues in oil- or gas-extracting countries. In Azerbaijan, for example, oil-sector receipts account for almost half of all government revenues, or 10 percent of GDP in 2004.

Monetizing in-kind transit payments

What can Georgia do to boost revenues from the new pipelines? The authors suggest that the authorities develop plans to monetize in-kind fees from transiting gas—a strategy that would require a significant improvement in payments discipline among consumers in the domestic gas sector—or consider taking cash as a transit fee.

Consumers fall into three different categories: large power generation/industrial clients, distributors, and others, mainly small-scale businesses. Payments discipline is highest in the latter segment. Enforcing discipline from large-scale direct clients has proven much more difficult, because these entities are perceived as "systemically important," complicating the enforcement of a tough disconnection policy. Payments discipline for gas sold to distributors has also been poor, because they have been unable or unwilling to enforce discipline on their own customers. For example, the cash collection rate of Tbilgazi, the municipality-owned distributor in the capital, amounted to less than 30 percent in 2002 and approximately 23 percent in 2003, although it did improve to 33 percent in 2004.

Monetization of gas received as a transit fee is further complicated by Georgia's commitment to buy additional gas from the SCP consortium at a discounted price for at least the first five years of the project. The authorities need to develop as soon as possible a strategy to deal with these issues—especially to find paying customers at home or abroad and to build or rent storage capacity. If it becomes difficult to monetize the additional gas (which Georgia is now committed to purchase) at low transaction and storage costs, the authorities may want to consider taking cash as a transit fee.

Recent experience in the Commonwealth of Independent States (CIS) reinforces the conclusion that monetizing in-kind gas transit fees may be difficult. Ukraine receives about 25 billion cubic meters a year in in-kind transit fees from Russia to compensate for the use of its gas pipeline network to transport Russian gas to Western and Central Europe, as well as to southern parts of Russia and to other CIS countries. If sold at $50 for every thousand cubic meters, these fees would be worth more than $1 billion a year. But the company that receives and handles the fees, Naftogaz, is the largest delinquent taxpayer in Ukraine, runs arrears on its payments for imported gas from Russia and Turkmenistan, and has not been able to make the investments needed to properly maintain trans-Ukrainian pipelines in recent years. Owing to a combination of underpricing and poor collection rates, Naftogaz's cash flow is inadequate. Clearly, Georgia will need to do a much better job in monetizing in-kind transit fees—or take the cash option instead.

The authors conclude that the superiority of the in-kind remuneration for SCP transit services is, at best, questionable. In the transition to strict enforcement of payments discipline in the energy sector, it would be more prudent to take cash payment for SCP transit services and evaluate the early experience in monetizing the additional gas that Georgia has committed to purchase. If that works well, Georgia could switch to in-kind remuneration for transit services at a later stage.

Assumptions for Georgia's transit revenue estimates

- Over the projection period (2005–12), BTC will be used to transport oil from the Azeri-Chirag-Gunashli (ACG) oil field; potential transport of Kazakhstan's oil via the pipeline has not been factored in, since no concrete agreements have been reached to date.
- BTC will be used for exports of ACG oil that cannot be accommodated by the existing western (Baku-Supsa) route. Given the lower transit fee for BTC ($0.12 a barrel), Georgia's revenues from oil transit would be reduced if oil is redirected through BTC.
- Georgia will receive 5 percent of the gas transported through SCP as a transit fee and will be able to sell that gas for $100 for every thousand cubic meters in the first year (the price will then rise by 2 percent a year).
- The transit fees from SCP are based on the contract with Turkey that was agreed in 2001. The fees could increase if additional buyers of Shah Deniz gas are found.
- Possible profits from Georgia's right to purchase additional gas transported through SCP have not been taken into account.
- Georgia does not incur significant costs for policing the pipelines.

Enhancing transparency

Given Georgia's limited expected revenues from transit fees, the country will not need to concern itself with the fiscal issues associated with price volatility, exhaustibility of the revenue stream, or exchange rate volatility that oil-producing or other resource-rich countries typically face. It will therefore not be necessary to create a natural resource fund for stabilization or saving purposes. Instead, the authors conclude, additional resources should be incorporated in the general government budget and used to defray the cost of urgent social and infrastructural needs.

To ensure that transit fee revenues are appropriately used, the authors urge the Georgian government and British Petroleum to practice maximum transparency in reporting and utilizing transit fees. To this end, they say, the Extractive Industries Transparency Initiative could provide Georgia with a useful framework for adequate reporting. But the template that has been developed by the initiative—prepared with oil- and gas-producing countries in mind—should be extended to allow for easy reporting by oil- and gas-transiting countries. The Georgian authorities have taken a promising first step in this regard by agreeing in principle to become a pilot country under the initiative. ■

This article is based on IMF Working Paper No. 04/209, *In the Pipeline: Georgia's Oil and Gas Transit Revenues*, by Andreas Billmeier, Jonathan Dunn, and Bert van Selm. Copies are available for $15.00 each from IMF Publication Services. Please see page 232 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Country focus

Mauritius must step up its competitiveness

For the past 25 years, Mauritius has enjoyed strong economic growth and, since its independence from the United Kingdom in 1968, seen peaceful political transitions. But with global competition heating up and several preferential trade arrangements lost or sharply curtailed, this open and resilient economy must step up its competitiveness and adapt its products to continue its economic success.

Mauritius has bucked the trend of stagnation and poverty and succeeded in building a vibrant economy and raising the living standards of its population of 1.2 million. Between 1980 and 2004, economic growth averaged 5½ percent a year and annual per capita income rose from $1,610 to $4,340 at constant 2000 prices and exchange rates (see chart, below). To achieve this success, the country over the past quarter century has diversified its economy from a reliance on a single export commodity—sugar—to other activities such as tourism, export processing (mainly textiles), financial services, and, more recently, information and communications technology.

Bittersweet

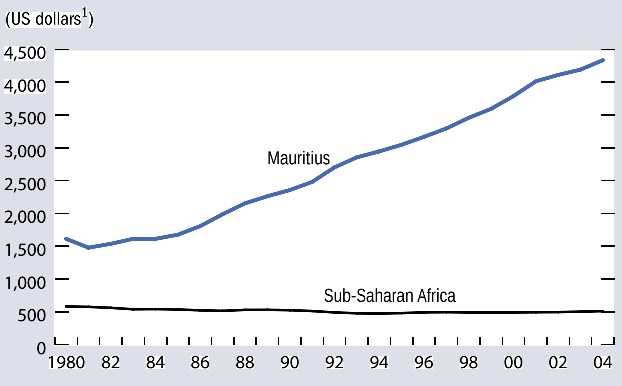
Despite this diversification, however, sugar remains an important part of the economy, generating about 15 percent of merchandise exports. Through its participation in the African-Caribbean-Pacific group, Mauritius has been exporting sugar to the European Union (EU) under the so-called Sugar Protocol that permits about 510,000 tons of its raw cane sugar to enter the EU duty free and at a preferential domestic price that is about three times the international free market price. Indeed, Mauritius is the protocol's main beneficiary, claiming some 40 percent of the total quota.

Following a recent successful challenge of the EU's sugar regime before the World Trade Organization, however, the EU agreed to cut the domestic price for sugar by 39 percent over two years. The EU will partly compensate European growers for lost income, but this decision is expected to cost Mauritius as much as $125 million a year in lost export revenue.

While this downward revision in the EU sugar price was perhaps not a surprise, the depth of the cut and the short transition period do present formidable challenges. It is hoped that the sharply lower EU prices will reinvigorate the Mauritian sugar industry's determination to cut production costs by improving productivity. The sugar industry is likely to continue to shed excess labor through a voluntary retirement scheme, consolidate milling operations, and diversify its markets into such areas as electricity cogeneration, and rum and ethanol production.

Rising incomes

While real per capita income has stagnated in sub-Saharan Africa, it has nearly tripled in Mauritius.



[1]At 2000 prices and exchange rates.
Data: Mauritius Central Statistics Office; Bank of Mauritius; and IMF staff estimates.

Shrinking textile opportunities

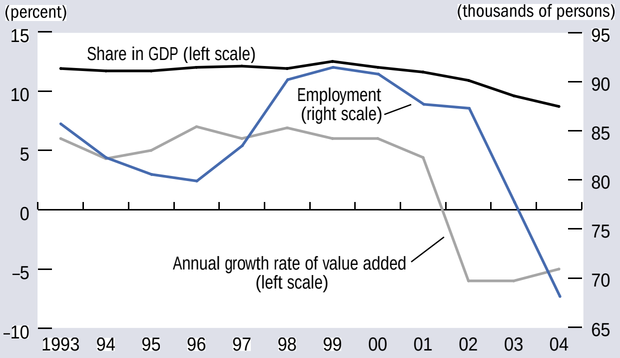
Textiles have been the driving force behind Mauritius's successful industrialization over the past 25 years, dominating its export-processing zone and benefiting from unrestricted access to the European, and to a lesser degree the U.S., markets. Beginning this year, however, the lifting of quotas has given low-cost producers, such as China and India, unrestricted access to the major textile markets in Europe and the United States.

The impact on Mauritius was felt well in advance of January 2005. For the third year running, the contribution of its export-processing zone to output growth has shrunk by about 5–6 percent, reducing its share in the economy from 12 percent in 2000 to less than 9 percent in 2004. More important, employment in the zone has dropped from a peak of 90,700 in December 2000 to 68,000 in December 2004, with some 20 of the largest, mainly foreign-owned, companies closing shop and relocating to China and Taiwan Province of China (see chart, next page).

The recent U.S. and European response to the surge in Chinese textile exports may provide a temporary reprieve for Mauritius's textile exports. Over the longer run, however, its textile industry will survive only if it succeeds in special-

Lost jobs

Mauritius's export-processing zone has suffered steep declines in jobs and value added since 2000.



Data: Mauritius Central Statistics Office.

izing in high-value niche markets with a dedicated commitment to high-quality products.

But not all is gloom and doom. Tourism and financial services continue to provide sound opportunities for growth.

Sun, sand, and sea

While most of Mauritius's "economic miracle" in the 1980s and 1990s focused on the export-processing zone, the performance of the country's tourism sector was equally remarkable. Indeed, between 1985 and 2000, the Mauritius tourism sector, measured by the number of tourist arrivals, grew by some 340 percent, far outpacing other regional competitors such as Maldives and Seychelles. Another sign of the resilience of Mauritius's tourism industry is its performance following the September 11, 2001, attacks in the United States. Unlike most international tourist destinations, including those in the Indian Ocean, Mauritius's tourism sector continued to grow in 2001 and 2002.

The Mauritius tourism sector is largely homegrown, with a number of luxury hotel chains based in Mauritius and majority-owned by Mauritian entrepreneurs. The authorities have contributed to the sector's success by promoting Mauritius as an exclusive destination, including by discouraging mass tourism through a restrictive air access policy. They have justified this strategy by the need to avoid overcrowding and to preserve the island's delicate ethnic and social balance. The result has been the development of a tourism product that is directed primarily at the high-spending European market. Tourism is expected to continue to grow in the foreseeable future and will remain an important sector that provides valuable employment opportunities.

Solid financial system

Mauritius has one of the oldest and most sophisticated financial systems in Africa. It is not only well capitalized, it is also highly profitable. While the banking system was already well developed at independence, the robust economic performance over the past quarter century strongly contributed to its further expansion. At the same time, the solidity and sophistication of the financial sector facilitated the economy's diversification. Thus, a virtuous cycle was established in which the financial system and the productive sector strengthened in parallel, with each sector supporting the other and contributing to its modernization and profitability. A strong regulatory framework and monetary policy aimed at maintaining macroeconomic stability also helped bolster the soundness of the financial system. There is every reason to believe that the financial sector will continue to play this critical role in the Mauritius economy.

Challenges ahead

All of that said, however, if the economy's transition to new and more dynamic activities is to be facilitated, policymakers will need to redouble their efforts to maintain macroeconomic stability and an open economy, while preserving social cohesion. Markets will also need increased flexibility, particularly in the highly regulated labor market.

Mauritius has succeeded in establishing strong institutions, including a well-functioning government administration, an independent judiciary, an efficient and well-regulated financial sector, a vibrant private sector, and, most important, a stable and democratic political system. Given the strength of these institutions, and the social consensus of its people, Mauritius is well positioned to take on the economic challenges it faces. ■

Emilio Sacerdoti and Gamal El-Masry
IMF Monetary and Financial Systems and Western Hemisphere Departments

For more details, see *Mauritius: Challenges of Sustained Growth*, by Emilio Sacerdoti, Gamal El-Masry, Padamja Khandelwal, and Yudong Yao. Copies are available for $25.00 each from IMF Publication Services. Please see page 232 for ordering information.

Tanzania: Bright outlook for further growth, poverty reduction

Tanzania has made great strides in improving its economic performance over the past decade, pursuing an ambitious program of economic reforms supported by official development aid and other assistance from the international community. A recent IMF Working Paper concludes that prospects are favorable for Tanzania to achieve the UN Millennium Development Goal of halving the proportion of people living on less than $1 a day by 2015, if reforms of the rural economy are intensified. Volker Treichel of the IMF's African Department discussed his findings with Jacqueline Irving of the IMF Survey.

IMF Survey: The IMF's projections for Tanzania indicate that a continuation of recent policies would allow the economy to grow at 5 percent a year over the medium term. What policies and other factors are driving Tanzania's substantially improved growth performance since the mid-1990s?

Treichel: Tanzania's strong growth record over the past decade has largely been the result of three pillars of domestic policy. The first pillar is macroeconomic stabilization—appropriate fiscal and monetary policies—which has produced a rapid decline in inflation. The second pillar is broad-based liberalization, including liberalization of external current account transactions, the foreign exchange market, and agricultural prices. The third pillar is large-scale privatization.

All of these pillars of policy have had direct, positive effects on economic activity and have, in addition, contributed to higher foreign direct investment [FDI]. And higher FDI has translated into growth in sectors such as mining, tourism, construction, and services in general, and also manufacturing, which has been growing fast, albeit from a very low base (see table). Over the medium term, Tanzania must intensify these policies in certain areas—notably, the agricultural sector and the business environment—to yield more broad-based growth that benefits other sectors of the economy.

IMF Survey: Why has poverty declined more in urban than in rural areas since 1995?

Treichel: The main reason is that economic growth has been much higher in urban than in rural areas because the three pillars of policy have had larger effects on sectors of the economy predominant in urban areas. For example, the services, construction, and manufacturing sectors are all based in Dar-es-Salaam, in particular, and have a strong presence in some other cities. Although there are no separate national accounts for the urban versus the rural economy, my colleagues and I estimate that real GDP growth over the past five years was more than 6 percent annually for Dar-es-Salaam, compared with only 4 percent annually for Tanzania overall. The difference reflects very low growth in the rural economy. The bottom line is that the pattern of poverty reduction that we have observed is broadly consistent with the pattern of growth. If growth continues at recent rates in urban areas and slightly accelerated rates in rural areas, however, prospects are favorable for Tanzania to attain its goal of halving income poverty by 2015.

IMF Survey: Given the large numbers of the Tanzanian population living in rural areas and employed in agriculture, poverty reduction hinges largely on an effective rural development strategy. What are the main elements of that strategy?

Treichel: Agricultural performance has varied significantly by crop. Since the mid-1990s, tea, tobacco, and cashew nut yields have improved quite a bit, but cotton and coffee, which employ very large segments of the economy, have grown more sluggishly. So, there is no "silver bullet" that will stimulate accelerated growth across the agricultural sector. It is important to carefully examine the sectoral pattern of economic activity—crop by crop—and assess the obstacles that must be overcome to improve production. One key measure would be to restructure the crop boards to strengthen pro-

Rising growth and declining inflation

Effective fiscal and monetary policies, liberalization, privatization, and higher investment have helped spur growth.

	1990–95		1996–2004	
	Annual average	Contribution to growth performance	Annual average	Contribution to growth performance
	(percent)	(percentage points)	(percent)	(percentage points)
Real growth	2.7	...	5.0	...
Sectoral components of GDP				
Agriculture	3.6	1.7	4.0	2.0
Industry	1.5	0.2	8.1	1.4
Mining	11.8	0.1	15.5	0.3
Manufacturing	0.7	0.1	6.3	0.5
Electricity and water	4.4	0.1	4.9	0.1
Construction	0.3	0.0	9.4	0.4
Services	1.9	0.6	5.2	1.6
Trade, hotels, and restaurants	2.2	0.4	6.0	1.0
Transport and communications	4.1	0.2	5.3	0.3
Financial and business services	2.0	0.1	4.6	0.3
Public administration and other services	–1.5	–0.1	2.1	0.0
Inflation	29.9	...	8.2	...

Data: Tanzanian authorities.

ducer incentives. Important preliminary work in this area has already been done by the Tanzanian government in collaboration with the World Bank.

IMF Survey: What are the main downside risks to these relatively optimistic growth and poverty reduction scenarios?

Treichel: Clearly, a main downside risk is the impact of the HIV/AIDS crisis, which has hit large segments of the rural as well as urban population. Human capital has also been negatively affected by the lack of appropriate education opportunities for the Tanzanian population. Education policies need to improve, especially at the secondary level. This has been a constant concern of the business community—one that has been continually raised at the Investors' Round Table and various other forums designed to improve the country's business and investment climate. Intensified efforts in this area might be able to counteract somewhat the negative impact on human capital of the HIV/AIDS crisis—in spite of the enormous dimensions of that crisis.

A second main downside risk is sluggish private sector development. Tanzania will need to remove impediments to private sector development and to improve its business environment, specifically by strengthening tax policy and administration, and improving infrastructure and governance.

Eugene Salazar/ IMF

Many policy reforms are now under way that could boost economic growth above 5 percent a year if these efforts are sustained.

—Volker Treichel

Policy implementation is the key to addressing these downside risks. Many policy reforms are now under way that could boost economic growth above 5 percent a year if these efforts are sustained. In the tax area, for example, Tanzania has made great progress over the past few years in streamlining tax administration, broadening the tax base, and improving tax collection. There also have been various reforms in recent years to improve the efficiency of import clearance procedures at the port of Dar-es-Salaam.

IMF Survey: Your paper mentions the effectiveness of financial sector reform, which has substantially increased the credit available to the private sector in the past several years. Nevertheless, critical segments of the private sector—particularly in rural areas—continue to lack access to financing. What can be done to address this?

Treichel: The joint IMF–World Bank Financial Sector Assessment for Tanzania in 2003 provides a road map for addressing this. Important initiatives include changes to the institutional and regulatory environment for the financial sector, including the opening of a credit reference bureau, which serves as a source of information to banks about prospective borrowers' credit histories. The privatization of the National Microfinance Bank, currently under way, will be another step forward. The bank's huge branch network could significantly improve access to credit by small enterprises. Now the challenge will be to implement these and other recent financial sector reforms—a process that unfortunately is impeded by weak capacity.

IMF Survey: Many economists, such as William Easterly, Ross Levine, and Dani Rodrik, stress the importance of sound institutions for sustainable economic growth. How is Tanzania faring in this regard?

Treichel: The quality of institutions is critical. In a sense, the weaknesses in Tanzania's business environment point to a lack of sound institutions. Better institutions would help address the private sector's complaints about tax and customs administration. Similarly, weaknesses in governance are effectively weaknesses in the quality of institutions. Weaknesses in the legal system, including poorly enforced contracts, are a similar issue of the quality of institutions. Even poor infrastructure is linked to poor institutions. The execution of road construction/maintenance and power generation projects, for example, can be impeded by a lack of adequate institutional and human resources capacity. ■

Copies of IMF Working Paper No. 05/35, *Tanzania's Growth Process and Success in Reducing Poverty*, are available for $15.00 each from IMF Publication Services. Please see page 232 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Making surveillance more effective

The ongoing dialogue between the IMF and its member countries on their economic policies—surveillance, in IMF-speak—is a key component in the institution's mission to help ensure a stable international monetary system and prevent crises. Given the importance of surveillance, the IMF carries out biennial reviews to maintain and improve its effectiveness. While every review makes recommendations for strengthening surveillance, the IMF's Executive Board did something new at its most recent review in July 2004. It identified six priorities and charged staff with monitoring progress toward achieving these priorities. Lynn Aylward of the IMF's Policy Development and Review Department reports on the staff's role and the progress to date.

The ultimate objectives of the IMF's economic policy oversight and advice remain the same today as they did in 1977, when the Executive Board adopted the decision that put surveillance into effect. But the framework for surveillance is far from static. Lessons learned from major international developments and events have helped shape its evolution. In its most recent review, the Executive Board recommended that the IMF prioritize and monitor the goal it sets for surveillance. In particular, the review established six priority objectives: a sharpened focus in the IMF's regular ("Article IV") consultations with member countries; a deeper treatment of exchange rate issues; enhanced financial sector surveillance; greater attention to regional and global spillovers in country surveillance; progress in improving debt sustainability and reducing balance sheet vulnerabilities; and further work on surveillance in low-income countries.

As a first step in pursuing these priorities, the IMF updated and fine-tuned the guidance that it provides to its own staff. These guidelines reflect what the institution has learned about how to carry out a well-focused and high-quality assessment. What do these guidelines emphasize in the six priority areas?

Tackling the priorities

Sharpening the focus. To sharpen the focus of Article IV consultations, surveillance must take into account the breadth of potentially important topics but, ultimately, maintain a selective approach, focusing on the issues that are key for each country. The IMF's surveillance is no longer limited to fiscal, monetary, and exchange rate policies—as was the case in its earliest days. It now also covers financial sector issues and those structural and institutional issues that affect macroeconomic conditions and prospects. Capital account developments, debt sustainability analyses, assessments of vulnerability to balance of payments or currency crises, and attention to governance and social issues are also part of the package.

While this evolution—some would say expansion—keeps surveillance effective, it is also a challenge for staff to maintain a fine balance between focus and breadth. To respond to the Board's call for greater focus, the staff has, among other steps, taken a more discriminating approach in its coverage of issues outside the Fund's traditional areas of expertise. The staff has always selected topics for Article IV consultations based on their macroeconomic relevance and, within the selected topics, concentrated on the issues at the top of the Fund's "hierarchy of concerns"—that is, topics related to external sustainability, vulnerability to balance of payments or currency crises, sustainable growth with price stability, and the systemic or regional impact of policies in large economies.

> In the wake of the 2004 review, IMF staff is being more selective in the level of coverage given to trade matters and to macroeconomically relevant areas outside traditional areas of Fund expertise.

In the wake of the 2004 review, IMF staff is being more selective in the level of coverage given to trade matters and to macroeconomically relevant areas outside traditional areas of Fund expertise. In particular, there is greater attention to whether such topics are well integrated with the overall policy discussions and make good use of existing sources of information from the Fund (such as Reports on the Observance of Standards and Codes (ROSCs)) as well as from the World Bank and other reputable sources. Staff are also working toward a strategic identification of topics for each country's consultation, through "pre-brief meetings" within the IMF and through an exchange of views with country authorities on priority topics at an early stage.

More attention to exchange rates. In response to the Executive Board's call for a more candid and pointed treatment of exchange rate issues, the staff are making more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness. They are ensuring that each Article IV consultation report includes an accurate description of the exchange rate regime, a candid appraisal of its appropriateness and consistency with underlying policies, and a forthright assessment of the exchange rate level. Renewed efforts to strengthen the treatment of exchange rate issues include presenting the policy dialogue between staff and the authorities in a comprehensive and balanced manner, particularly when views differ between them.

Stronger oversight of the financial sector. The Asian financial crisis, which demonstrated that even countries with relatively sound macroeconomic policies can get into serious trouble when their financial systems have weaknesses, prompted the IMF to make the financial sector a core area of its surveillance. While substantial progress has been made in this area, including through the joint IMF–World Bank Financial Sector Assessment Program (FSAP), the July 2004 review found that the coverage of financial sector issues was not yet on a par with coverage in the IMF's traditional core areas of fiscal, exchange rate, and monetary policies.

Massoud Etemadi/IMF

To remedy this, the Board called for enhanced financial sector surveillance. Staff now aim to make use of all available options to bring the necessary expertise to bear on the analysis of the financial sector. This means drawing on FSAP reports, reassessments, and updates, and involving experts from the IMF's Monetary and Financial Systems and International Capital Markets Departments in Article IV consultations or in "stand-alone" missions that would concentrate on financial sector issues and contribute to an Article IV team's overall assessment of the economy. The main conclusions of financial sector analyses are also being better integrated into the overall vulnerability assessment and policy discussion for a given member country.

Factoring in regional and global developments. To help ensure that country surveillance is fully informed by regional and multilateral surveillance exercises, Article IV reports now more explicitly link past and prospective economic performance to global economic and financial conditions. They also provide more in-depth analysis of key country-specific vulnerabilities related to global economic and financial risks.

Where relevant, staff reports outline the potential impact of important economic developments in major regional or trade partners and offer more detailed analyses of the issues raised under multilateral surveillance and relevant to particular countries. IMF economists who carry out surveillance in large countries are paying closer attention to the regional or systemic impact—the spillover effects—of these countries' economic developments and policies. And, related to the call for integrating country, regional, and multilateral surveillance, the staff are deepening country analysis by making more use of the IMF's cross-country comparative studies.

Measuring improvement. In its July 2004 review, the Executive Board also called for progress in helping member countries improve debt sustainability and reduce balance sheet vulnerabilities. There is early evidence that the IMF's current emphasis on strengthening vulnerability assessments has already borne fruit. Components of vulnerability assessments have been worked into overall policy discussions with member countries; there is continued attention to the policies needed to address risks detected in these vulnerability assessments, and further refinements have been made in analytical techniques.

With regard to the conduct of surveillance in low-income member countries, staff are using Article IV consultations to strengthen analysis of external shocks that could derail growth trends in poor countries and they are analyzing alternative macroeconomic frameworks under different aid flow assumptions.

All of these measures are providing a good basis for assessing whether the IMF is indeed improving the effectiveness of its surveillance, a quintessential question for the next review of country surveillance. ■

Lynn Aylward
IMF Policy Development and Review Department

Why measuring governance matters

Development is all about governance these days. When the Group of Eight (G8) countries announced their decision to double aid to Africa on July 8, a whole section in their communiqué was devoted to "promoting good and responsive governance." And while attaching fewer strings to aid is the new mantra of the development community, governance is one area where recipient countries can expect to face much greater scrutiny. But what exactly is governance, and how is it measured? Aart Kraay, one of the pioneers of the World Bank's governance indicators database—viewed as the state of the art within the development community—gave a tour d'horizon of governance at a June 16 seminar arranged by the IMF Institute.

The World Bank's database includes six dimensions of governance (see box, next page), ranging from "voice and accountability" to "control of corruption." The data cover 209 countries over an eight-year period (1996–2004) and are derived from 37 separate data sources that include cross-country surveys of firms, commercial risk-rating agencies, think tanks, government agencies, and international organizations.

Almost all of this material is perception based. Why? Kraay explained that it makes sense to use subjective data (for instance, asking firms if they think government interferes with investment decisions) as opposed to objective data (for instance, counting the number of police patrolling the streets). Perceptions are what really matter when it comes to governance, because *de jure* rules often are not followed, or are abused. A country can have proportional representation, but if elections are routinely rigged, the election system matters very little. For these reasons, governance indicators that rely on subjective data are actually more informative about certain dimensions of governance than those relying on objective data.

> Governance is not a luxury good that only wealthier countries can afford.
>
> —Aart Kraay

An imperfect business

If one accepts this premise, the next question is: Just how precise are the indicators? Is it justifiable to give aid to one country but cut it back for another based on data collected in this manner? Kraay did not address that question directly, but he did discuss the quality of the indicators at length. Many changes in the governance indices are small relative to the margins of error, even over the eight-year period covered by the indicators, and there is a lot of "noise" in the data, he said. The margins of error, which vary from country to country, are normally attributable to two factors: cross-country differences in the number of sources used to assess governance for individual countries, and differences in the reliability of the sources used for each country.

Countries where changes in governance—as measured, for instance, by a change in voice and accountability—were within the margin of error, and therefore insignificant, included Bolivia, Brazil, and the Philippines. But for other countries, including Haiti, Ivory Coast, Nepal, Venezuela, and Zimbabwe, governance deteriorated markedly, whereas it improved in Latvia, Serbia, Sierra Leone, and Tanzania. Kraay said his team estimates that actual changes in governance are about half as large as *observed* changes, so that should be taken into account when using the database. Crucially, however, these margins of error are not unique to subjective or perception-based measures of governance. Rather they are pervasive in any effort to measure governance using any type of data, and it is important for policymakers to take this uncertainty into account.

Governance and growth

Economists have known for some time that there is a highly significant correlation between governance and economic growth over the long run, but the precise nature of this relationship is difficult to pin down. This is because several other factors also matter for growth, including geography, trade, human capital, and different types of institutions. New research has tried to approach the problem by running "horse races," for instance between the effect of trade and governance on growth, but much more work remains to be done, Kraay said, before economists can get a clearer picture of how governance relates to growth.

Even so, the World Bank estimates that a country that improves its quality of governance from a low to an average level can quadruple the income per capita of its population in the long term, and similarly reduce infant mortality and illiteracy. And the direction of causality is clear: it goes from better governance to higher incomes, and not vice versa.

In other words, Kraay said, governance is not a "luxury good" that only wealthier countries can afford. This also implies that the weak governance performance observed in many poor countries should not be "discounted" based on their low incomes—both rich and poor countries can improve their governance regardless of their income levels.

Growth without governance

Unfortunately, this also implies that higher incomes do not necessarily lead to better governance. New research by Kraay and his colleagues shows that the absence of a virtuous circle between growth and governance means that the hard work of rooting out corruption must be done regardless of a country's economic performance. In fact, there may even be negative feedback from per capita income to governance—especially in the face of undue and illicit influence of the elite in shaping the laws, policies, and regulations of the state—what Kraay refers to as "state capture."

State capture differs from conventional corruption—the use of bribery to influence the *implementation* of laws and regulations—and has a potentially wider impact. State capture can severely hinder a country's ability to benefit from economic growth: if the fruits of income growth largely accrue to an elite that benefits from misgovernance, then any possible positive impact of income growth on governance could be offset by the elite's negative influence, Kraay argued. Recent research has identified state capture as a fundamental challenge in many transition countries, with evidence suggesting that it is widespread in Latin America as well.

> State capture can severely hinder a country's ability to benefit from economic growth: if the fruits of income growth largely accrue to an elite that benefits from misgovernance, then any possible positive impact of income growth on governance could be offset by the elite's negative influence.
>
> —Aart Kraay

So where does that leave Africa and G8 aid and debt relief? While low-income countries will likely have to contend with tough new demands from donors wanting to make sure that their aid is being put to good use, there is still precious little advice on how exactly to achieve that coveted improvement in institutions and the rule of law. But at least we now have a somewhat clearer picture of what governance looks like, how it is evolving across the world, and how important good governance is for economic development. ■

Camilla Andersen
IMF External Relations Department

Making sense of governance

The World Bank's governance database is based on the following six dimensions:

- ***Voice and accountability*** includes indicators that measure various aspects of the political process, including civil liberties, political and human rights, and the extent to which citizens of a country are able to select their governments.
- ***Political stability and absence of violence*** combines several indicators that measure perceptions of the likelihood that a government will be destabilized or overthrown by unconstitutional means, including through domestic violence and terrorism.
- ***Government effectiveness*** combines responses on the quality of public service, the independence of the civil service from political pressure, and the credibility of the government's commitment to various policies.
- ***Regulatory quality*** focuses on policies that hamper the functioning of an efficient market, such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.
- ***Rule of law*** includes several indicators that measure the extent to which citizens have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the ability to enforce contracts.
- Finally, ***control of corruption*** is a measure of corruption, conventionally defined as the exercise of public power for private gain. It is based on scores of variables from polls of experts and surveys.

For more information about the World Bank's work on governance, please visit *www.worldbank.org/wbi/governance/index.html.* The governance indicators are available at *www.worldbank.org/wbi/governance/govdata.*

Central America looks to deepen economic integration

After a so-called lost decade in the 1980s, when civil conflicts and economic disruption paralyzed the region, Central America has made great strides in embracing peace, democracy, and market-oriented reforms. Nevertheless, poverty remains widespread, key institutions need bolstering, and regional cooperation is still at an early stage in many areas.

An IMF book forum on July 21 took up the region's prospects, showcasing a new Occasional Paper (see box) and drawing on the perspectives of two ambassadors and a Washington-based policy analyst.

As background for the discussion, Markus Rodlauer and Alfred Schipke (IMF Western Hemisphere Department and editors of the Occasional Paper) reviewed the economic, social, and political context in which policymaking is taking place. Also discussed were the macroeconomic implications of a free trade agreement between the region, the Dominican Republic, and the United States (CAFTA-DR), which holds the promise of further economic integration and strengthened competitiveness in global markets.


Eugene Salazar/IMF

Nicaragua's Ambassador to the United States Salvador E. Stadthagen.

Trade, investment, and growth

Rodlauer and Schipke noted that CAFTA-DR has the potential to increase trade, investment, and growth, and lower output volatility. But capturing these benefits will require reforms to improve the environment for private investment, in particular by strengthening institutions and the rule of law. They also stressed the need to shore up fiscal revenues (notably through improved tax coordination within the region) and address high public debt levels (except in Guatemala). Strong supporting measures, they said, hold the key to bringing home the benefits of integration.

For Salvador E. Stadthagen, Nicaragua's Ambassador to the United States, the IMF study confirmed his expectations that the agreement would boost foreign direct investment (FDI). "For Nicaragua, where the capital base is very shallow," he said, FDI is indispensable. He also saw the agreement as a key signal of commitment and support to the region from its largest trading partner—thereby underpinning the democratic and market-oriented policy frameworks in place.

José Guillermo Castilla Villacorta, Guatemala's Ambassador to the United States, pointed to the Caribbean Basin Initiative of 1983, which had produced a fivefold increase in trade with the United States and a "huge diversification of exports." He emphasized the real opportunities for the poor offered by CAFTA-DR and the export-oriented growth strategy it embodies. Quoting a countryman, he observed that "we have been planting corn and beans for the past 100 years, and we have not been able to get out of poverty. This now is a real opportunity." He also hoped the pact would foster good governance, help strengthen institutions, and increase cooperation among nations.

Peter Hakim, president of Inter-American Dialogue, praised Central America's recent economic—and social—progress, but termed it still "widely inadequate." He also voiced concerns that peace and democracy were still fragile in the region. Nevertheless, he saw in CAFTA-DR an opportunity to raise growth, promote integration, and strengthen reform. But will its benefits help reduce poverty or simply accrue to a small elite? That, he said, was a crucial issue on which much of the success of CAFTA-DR would hinge. ■

Copies of Occasional Paper No. 243, *Central America: Global Integration and Regional Cooperation*, are available for $25.00 each ($22.00 academic rate) from IMF Publication Services. See this page for ordering details.

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