IMF work program focuses on strategic priorities

Managing Director Rodrigo de Rato outlined an ambitious new work program for the IMF, pledging that it would make substantive progress on several fronts before its September Annual Meeting. The agenda—designed to begin implementing de Rato’s medium-term strategy for the Fund—highlights efforts to strengthen IMF surveillance, bring voting shares more in line with current weights in the world economy, and explore new crisis prevention financing instruments for emerging market economies.

Panama: growth, reforms key to reducing inequality

Over the past 15 years, Panama has enjoyed strong growth rates, thanks to a sophisticated financial system and relatively sound fiscal policies. But advanced, export-oriented sectors coexist with an informal economy characterized by significant poverty and inequality. If the fruits of economic success are to be shared more widely, sustained economic growth will need to be coupled with expanded education opportunities, increased labor market flexibility, and improved governance.

Making cash conditional in Namibia

Although Namibia is a resource-rich, middle-income country enjoying macroeconomic stability, not all Namibians are benefiting. One-third of the population is poor, and unemployment and the incidence of HIV/AIDS are high. An IMF staff report proposes a way to help reduce poverty and income inequality by providing cash grants to poor families who invest, for example, in education, job training, or health care.

Is rapid growth leaving some Indian states behind?

Rapid growth is transforming India’s economy, but there are increasing fears that poorer states are not keeping pace. Indeed, a new IMF Working Paper finds widening disparities in average per capita incomes across states. The past need not dictate the future, however. Poorer states can learn from their prosperous neighbors—notably the importance of diversifying state economies away from agriculture or industry, raising investment, improving infrastructure, and pursuing sound fiscal policies.
**What’s on**

**July**

3–5 High-Level Meeting of the United Nations Economic and Social Council, Geneva, Switzerland

11–12 IMF High-Level Seminar on Crisis Prevention in Emerging Markets, Singapore

15–17 Group of Eight Summit, St. Petersburg, Russia

**August**

27–September 1 International Disaster Reduction Conference, Davos, Switzerland

**September**

7–8 13th APEC Finance Ministers’ Meeting, Hanoi, Vietnam

10–11 IMF High-Level Seminar on Financial Taxation, Singapore

10–11 China Business Summit 2006, Beijing, China

14–15 Raffles Forum on Good Governance and the Wealth of Nations, Singapore

19–20 IMF–World Bank Annual Meetings, Singapore

20–24 United Nations General Assembly, High-Level Meeting on the Review of the Brussels Program of Action for the Least Developed Countries, New York, United States

28 September 7–8 13th APEC Finance Ministers’ Meeting, Hanoi, Vietnam

10–11 IMF High-Level Seminar on Financial Taxation, Singapore

10–11 China Business Summit 2006, Beijing, China

14–15 Raffles Forum on Good Governance and the Wealth of Nations, Singapore

19–20 IMF–World Bank Annual Meetings, Singapore


**October**

23–27 IMF High-Level Seminar on Current Issues in Monetary and Financial Law, Washington, D.C., United States

**November**

6–7 IMF Symposium on Integrity Supervision of Financial Sector Firms, Washington, D.C., United States

9–10 Jacques Polak Seventh Annual Research Conference, IMF, Washington, D.C., United States

11–15 World Energy Council, 20th World Energy Congress and Exhibition, Rome, Italy

19–20 IMF–World Bank Annual Meetings, Singapore

19–20 United Nations General Assembly, High-Level Meeting on the Review of the Brussels Program of Action for the Least Developed Countries, New York, United States

23–24 World Economic Forum in Turkey, “Connecting Regions—Creating New Opportunities,” Istanbul, Turkey

26–28 World Economic Forum, “India: Meeting New Expectations,” New Delhi, India

**January 2007**

24–28 World Economic Forum Annual Meeting, Davos, Switzerland

**IMF financial data**

**Total IMF credit and loans outstanding, by region**

<table>
<thead>
<tr>
<th>Region</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>as of 4/30/06</th>
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<tbody>
<tr>
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<tr>
<td>Asia</td>
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<tr>
<td>Europe (includes Turkey and Russia)</td>
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<td></td>
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<tr>
<td>Middle East</td>
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<tr>
<td>Latin America and the Caribbean</td>
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</tbody>
</table>

**Major currencies, rates per SDR**

<table>
<thead>
<tr>
<th>Currency</th>
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<th>Year ago (June 20, 2005)</th>
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<tr>
<td>Euro</td>
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<td>1.204</td>
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<tr>
<td>Japanese yen</td>
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<td>159.836</td>
</tr>
<tr>
<td>U.K. pound</td>
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<td>0.804</td>
</tr>
<tr>
<td>U.S. dollar</td>
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**HIPC debt relief**

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<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>as of 6/15/06</th>
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<td>HIPC</td>
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</tbody>
</table>

**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:** 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.
Managing Director Rodrigo de Rato outlined an intensive agenda for the IMF over the next few months as the organization gears up for the joint Annual Meetings of the World Bank–IMF Governors in September in Singapore. The work program of the Fund’s Executive Board, released June 22, aims for substantial progress in this period in three key areas of the organization’s new medium-term strategy: strengthening surveillance, including proceeding with the first multilateral consultation; the development of concrete proposals on quotas and voice for agreement at the Annual Meetings; and, to meet the needs of emerging market economies, the development of a new crisis prevention instrument and proposals on how to support members’ reserve pooling arrangements. The agenda also sets out the IMF’s projected activities for the remainder of 2006.

The work program offers a road map and calendar of activities for the current state of implementation of the Fund’s medium-term strategy, which is designed to bolster the Fund’s role in supporting growth and stability in a rapidly expanding and increasingly integrated international financial system.

In three priority areas, the work program outlines clear actions:

**Surveillance.** Work is under way on the first multilateral consultation, which focuses on policies to narrow global imbalances. Participants are China, the Euro Area, Japan, Saudi Arabia, and the United States.

Also moving forward is work on updating a 1977 IMF Executive Board decision that forms part of the foundation for the Fund’s surveillance work. Before the Annual Meetings, the Board will begin discussing the broad role of surveillance in pursuing international stability and monitoring members’ observance of their commitments to the Fund, and ways in which the basis for exchange rate surveillance might be strengthened. The review of the decision will be completed after the Singapore meetings.

Staff work is proceeding as well on improving analysis and assessments of exchange rate policies and on developing an analytical framework for addressing financial sector issues in country surveillance.

**Governance.** De Rato said that, reflecting preliminary discussions, work will begin on the development of concrete proposals on quotas and voice, and “at least one substantive Board discussion” on this topic will take place in advance of the Singapore meetings.

**Emerging markets and crisis prevention.** In the lead-up to the Annual Meetings, the Executive Board will hold a preliminary discussion on the elements of a crisis prevention financing instrument. A discussion on how to support reserve pooling arrangements will give particular attention to helping those members that already have such arrangements in place.

**Other initiatives**

In keeping with its medium-term strategy, the IMF will work to improve the focus of its policy advice to low-income countries; better align its assistance for capacity building with members’ needs and evolving Fund priorities, particularly where surveillance has identified vulnerabilities; and streamline its own work to increase the organization’s efficiency and flexibility.

**Low-income countries.** To help low-income members achieve the Millennium Development Goals, the IMF is sharpening the focus of its policy advice, giving particular emphasis to the effective absorption of increased aid flows and debt relief, the provision of financial assistance, and institutional capacity. Before the Singapore meetings, the Board is expected to address debt issues and follow up on the debt sustainability framework for low-income countries.

**Capacity building.** The Fund’s medium-term strategy places priority on better aligning its capacity-building efforts with the needs of member countries and evolving Fund priorities, especially addressing the macroeconomic and financial sector vulnerabilities identified in Fund surveillance. In June, the IMF will circulate information on how reports on country observance of international standards and codes will be better integrated with Fund surveillance and technical assistance and on efforts to improve the clarity and timeliness of the reports.

**Streamlining.** A broad program of steps to improve the Fund’s efficiency and flexibility is moving forward. A proposal to streamline policy and other reviews is scheduled to be considered by the Board in July.

For more information, see IMF Press Release No. 06/138, which is available at www.imf.org.
De Rato highlights global risks and IMF initiatives

IMF Managing Director Rodrigo de Rato visited Australia and New Zealand June 13–16 to review global and regional economic issues and exchange views with the authorities on the IMF’s medium-term strategy. In a speech at the National Press Club in Canberra, de Rato said that although the global economy was doing well, downside risks, including from rising oil prices and global imbalances, had increased. A disorderly adjustment of the imbalances could lead to an economic downturn and global financial market disruptions that, de Rato noted, could seriously affect Asian emerging markets, which depend heavily on exports, and Australia, with its open trading economy.

There is increasing agreement on the policies needed to reduce global imbalances, he said, including fiscal adjustment and measures to stimulate private saving in the United States, further exchange rate appreciation and measures to stimulate domestic demand in some countries in emerging Asia, and structural reforms in Europe and Japan to stimulate demand and boost productivity.

Collective efforts

The Fund can also help, de Rato said, “because we are a global institution with a global constituency, because we are engaging with all governments in the world on a regular basis.” One proposal under the Fund’s medium-term strategy, he noted, is to “engage in multilateral consultations on issues of global or regional significance that will allow the Fund to help countries think collectively and decide collectively.” The first such consultation, focusing on narrowing global payments imbalances while maintaining robust growth, will bring together China, the Euro Area, Japan, Saudi Arabia, and the United States.

Another challenge, de Rato said, is the risk of volatile capital flows and financial contagion, to which economies around the world, including in Asia, must reduce their vulnerability. For that reason, the IMF is developing an instrument to provide financing to emerging market countries that have strong fundamentals but are still vulnerable to shocks.

De Rato also discussed how to ensure a fair voice for all members and quotas that reflect the evolving weight of countries in the global economy. He expressed his appreciation for the role that Australia, as chair of the Group of 20 developed and emerging market economies, is playing in advancing reform of the IMF.

In Canberra, de Rato met with Prime Minister John Howard, Treasurer Peter Costello, Minister for Foreign Affairs Alexander Downer, opposition Finance Spokesperson Wayne Swan, Deputy Governor of the Reserve Bank of Australia Glenn Stevens, and other senior officials, as well as members of the academic and business communities.

De Rato then traveled to New Zealand to meet with the authorities about global and regional economic issues. In a speech delivered in Wellington, he noted that increased trade had long been a cornerstone of growth for the global economy. But he said that time was running out on the Doha Round of multilateral trade talks and that failure to reach agreement would be very damaging. He therefore urged “all parties to look beyond narrow defensive interests and demonstrate their willingness to negotiate a substantive agreement in the time that remains.”

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IMF evaluation office urged to sharpen its focus

An external assessment has credited the Independent Evaluation Office (IEO) with serving “the IMF well” but encourages it to do more to “avert the tendencies, pressures, and practices that may push it in the direction of becoming bureaucratized, routinized, and marginalized.”

The IEO was created in 2001 to enhance the Fund’s learning culture and bolster its external credibility through independent evaluations of IMF effectiveness. Asked to gauge how well these objectives have been met, a panel of outside experts, headed by former IMF Executive Director for the United States Karin Lissakers, consulted with country officials, academics, and nongovernmental organizations, as well as the IMF’s staff, management, and Executive Board.

The IMF’s Executive Board concurred with the panel’s major findings, notably that the IEO enjoyed strong support among its stakeholders, facilitated governance and oversight by the IMF’s Board, and was widely seen as acting independently. The Board also supported the recommendation that the IEO take steps to sharpen its focus and be more strategic to bolster its usefulness and relevance.

Among the panel’s other recommendations were that the IEO
• make greater use of “strong outside personalities with limited exposure to the Fund” to ensure a fresh view on topics and add value to the already extensive internal reviews;
• follow up more systematically on IEO recommendations and monitor implementation; and
• completely overhaul dissemination and outreach activities—particularly in developing country and emerging market economies where the Fund’s role is most contentious.

For information, please see the full text of the report on the IMF’s website (www.imf.org/external/np/pp/eng/2006/032906.pdf).
Fiscal sustainability is critical if Swaziland is to fight poverty

Swaziland’s economy has stagnated over the past 10 years, and this trend appears likely to continue. Real GDP growth is projected to be 1.0 percent in 2006, slowing from an estimated 1.8 percent in 2005 and 2.1 percent in 2004, according to the IMF’s annual economic review. A prolonged drought, real effective appreciation of the exchange rate, increased oil import prices, and the removal of textile quotas in industrial countries have contributed to the adverse developments. The fiscal deficit increased to 4.3 percent of GDP in FY2004/05, from 2.7 percent of GDP in FY2003/04, owing in large part to public sector salary increases. To finance the deficit, the government has depleted its financial assets and accumulated domestic arrears.

In October 2004, Swaziland issued a Poverty Reduction Strategy and Action Plan that aims to halve the poverty rate by 2015, in keeping with the Millennium Development Goals. Little progress has been made, however, and poverty and food shortages remain widespread. Encouragingly, the HIV/AIDS infection rate for the 15–19 age group declined for the first time in 2004 (to 29 percent, from 32 percent in 2002), suggesting that preventive measures may have begun to take hold.

The IMF Executive Board stressed that improving fiscal sustainability and external competitiveness will be critical to reducing poverty in Swaziland, and the further loss of trade preferences and expected decline in revenues from the South African Customs Union will only complicate these challenges.

Directors urged the authorities to pursue fiscal consolidation and structural reforms without further delay. Sharply reducing the budget deficit will be imperative, given the absence of concessional external financing, the presence of large payments arrears and contingent liabilities, limited scope for domestic borrowing, and low economic growth. Structural reforms will be necessary to support fiscal consolidation, Directors pointed out, particularly measures to increase labor productivity, reduce domestic costs, and improve the investment climate.

Sustaining reforms and improving investment climate are crucial for Philippines

The Philippines’ GDP grew by 5.0 percent in 2005, boosted by buoyant services, such as business process outsourcing, telecommunications, and tourism. Despite higher oil prices and intense regional competition, the balance of payments remained strong. But, largely because of the oil price increases, average inflation for the year was significantly above the central bank’s target range of 5–6 percent.

Since taking office in mid-2004, the administration has raised tariffs on power generation to cut the power company’s losses and fully implemented the value-added tax reform. Political turbulence in mid-2005 disrupted economic reforms, but the authorities kept fiscal consolidation on track, and uncertainties receded. Fiscal performance in 2005 was better than targeted, and the national government deficit was substantially lower than in 2004, with equal contributions from buoyant revenues and expenditure underruns.

Export growth, weighed down by anemic electronics growth, was 3¾ percent in 2005, and oil-related imports were offset by higher remittances. Equity inflows were sizable, and foreign reserves (adjusted for pledged assets) reached $18.0 billion at end-2005. If economic reforms were to stall, investment would probably remain subdued and keep GDP growth below 5 percent in 2006. Heavy reliance on external commercial borrowing also puts the Philippines at risk, a point underscored by the recent turbulence in emerging markets.

The IMF Executive Board commended the authorities for regaining the reform momentum but emphasized the importance of further enhancing the investment climate to set the stage for higher economic growth and substantial poverty reduction. The Directors expressed concern about weaker export performance and stressed that a stable macroeconomic environment, increased infrastructure investment, a stronger financial system, and improved governance would be key to increasing the rate of investment and enhancing competitiveness.
Over the past 15 years, a sophisticated financial system, relatively sound fiscal policies, and a number of structural reforms have helped spur economic growth in Panama. But not all Panamanians have benefited equally. Advanced, export-oriented sectors coexist with less prosperous domestically oriented ones, including an informal economy characterized by significant poverty and inequality. How can Panama ensure that the fruits of economic success are more widely shared? Sustained economic growth is a necessary underlying condition for poverty reduction, but expanded educational opportunities, increased labor market flexibility, and improved governance will also be crucial.

Panama has a dual economy. Its sophisticated regional financial center, newly modernized Panama Canal, booming construction industry fueled partly by foreign demand, and rapidly growing tourism and other industries oriented toward the export of services coexist with a 37 percent poverty rate and persistent unemployment, notably in rural areas. Indeed, a large share of the labor force, lacking the skills needed to take up jobs in Panama’s fast-developing industries, is still concentrated in the informal sector.

**Strong growth, persistent inequality**

Between 1990 and 2004, Panama was the second-fastest-growing economy in Latin America (see chart below left). Its GDP per capita, $4,400 in 2004, is high by regional standards (adjusted for purchasing power parity, it is estimated at about $7,000).

But strong economic growth, with a 14 percent increase in GDP per capita between 1997 and 2003, has not yet translated into significant poverty reduction. Over the same period, the poverty rate declined by only ½ of 1 percentage point to 37 percent. In 2003, an estimated 63 percent of the rural population continued to live in poverty, and one in six Panamanians lived in extreme poverty—that is, on less than $1.50 a day. Only 2.2 percent of the population has been lifted out of extreme poverty (see chart below right). Why have high rates of poverty persisted? High unemployment has been one factor. Although the unemployment rate has declined steadily since 2001, it remained in double digits until 2005, when it dropped to 9.6 percent. Average real wages have also been in decline since the start of the 1990s.

One intuitively expects economic growth to result in better overall standards of living, but empirical evidence on the relationship between inequality and growth is mixed. In the short run, increased growth tends to be associated with increased inequality. Measures to boost growth—such as tax cuts and incentives for particular industries or investors—can boost private sector activity, but they may make the tax system more regressive and deprive the country of revenues needed to finance poverty-reducing social programs.

However, over time, increased growth does tend to be associated with declines in inequality, though this relationship need not be causal. It can be driven by structural changes that both reduce inequality and poverty and enhance economic performance. Such changes include reforms designed to upgrade human capital (through expanded education and training), improve the efficiency of labor markets, strengthen the quality of governance, and facilitate the development of financial markets.
Roots of the dual economy
Consistent with this general theoretical argument, Panama’s dual economy can be explained by the success of tax incentives and mixed results with long-run structural reforms. The recent economic recovery has been driven by exports of services and construction. Both sectors benefited from generous tax incentives, including a 20-year property tax exemption for newly built properties. These incentives have intensified the dual-economy phenomenon by targeting particular industries and by allowing those who purchase expensive property to substantially reduce their tax obligations. The low level of overall tax collections (8.5 percent of GDP in 2004), which clearly reflects a low tax burden on the private sector, also constrains the government’s ability to finance social programs—especially since debt-interest payments absorb almost half of all tax revenues.

In its pursuit of long-run structural reforms, Panama has had more success on the financial side. Major strides have been made in developing credit markets, and these, in turn, have helped combat poverty by broadening access to credit and mitigating business start-up costs. More generally, the Panamanian financial system—aided by full dollarization, strong creditor rights, and prudent banking supervision and regulation—has developed rapidly, with credit broadly available to businesses and individuals. Growth has also been facilitated by privatization, transfer of the administration of the Panama Canal from the United States, establishment of special economic zones, and the use of concessions to encourage investment in infrastructure.

If it is to sustain high growth and make substantial progress in reducing poverty, however, Panama will need to take additional steps in a number of areas, notably human capital development, labor market rigidities, and the quality of governance.

Further reforms needed
Benefiting from its competitive advantages over other countries in the region, Panama’s transport, tourism, and telecommunications industries have significantly expanded exports of services. Rapid expansion in these areas, however, has quickly exhausted the supply of suitably qualified labor. A recent survey of labor demand and supply pointed to a shortage of experts in maritime disciplines, tourism, and certain technical subjects and a surplus of students of law and management. While the government’s efforts to promote English-language education programs are welcome, further measures (such as targeted government-supported training programs) are needed to ensure that the qualifications of the labor force match the demands of Panama’s rapidly developing industries.

The country’s growth rate and poverty reduction efforts could also benefit from measures to ease the comparatively rigid rules (see chart below) on hiring and firing staff and the use of overtime work. The rules are intended to protect workers but appear to achieve the opposite effect by encouraging businesses to use informal contractual arrangements. Indeed, workers in the informal sector (estimated to account for 42 percent of employment) often have lower wages, higher chances of being underemployed, and lower, if any, social security protection.

Panama can improve governance and streamline the heavy regulation of businesses—both steps that would be particularly helpful for small and medium-sized businesses. Streamlining the procedures for starting up and running small and medium-sized businesses and further increasing the transparency of public resources management need to be made priorities. Finally, Panama’s high debt-to-GDP ratio calls for strong fiscal discipline, which would substantially reduce the burden of servicing public debt and free up resources for much-needed social programs.

Alexander Plekhanov
IMF Western Hemisphere Department

High cost of rigidity
Panama’s rigid labor market rules appear to have led to higher informal employment.

Note: Higher values correspond to more rigid regulations. The index is based on hiring, firing, and overtime work regulations.

Every year, 13,000-14,000 ships, representing 5 percent of the world’s maritime trade, pass through the Panama Canal.
To reduce poverty, Namibia could explore conditional grants

Although Namibia is a resource-rich, lower-middle-income country, one-third of its population is poor. To address one of the most unequal income distributions in the world, a coalition of nongovernmental organizations has proposed a universal income grant for all Namibians under age 60. But such a program may jeopardize economic stability and compromise the country’s fiscal policy stance. According to a recent IMF staff report, a better approach to social assistance may be a conditional cash transfer program.

Namibia has a high incidence of HIV/AIDS and other diseases, high unemployment among the unskilled, instances of food insecurity, an inadequate education system, and a limited social safety net. The extreme inequality in incomes is largely the consequence of the economic and social structures inherited from the apartheid period and of the country’s dependence on the diamond industry.

Battling poverty on myriad fronts, Namibia is not on track to meet the Millennium Development Goals (MDGs) for child nutrition, under-5 and maternal mortality, and net primary school enrollment. The government has spent more (in relation to GDP) on health care and education than most other sub-Saharan African countries but has not always allocated expenditures efficiently. Although it has made strides in treating those with HIV/AIDS, this epidemic is still the country’s greatest challenge to human development. Moreover, the incidence of tuberculosis is increasing rapidly and is now among the highest in the world.

Weak safety net

In sub-Saharan Africa, Namibia is one of very few countries with a social safety net for vulnerable groups. It provides welfare grants to the elderly, the disabled, orphans and vulnerable children, and war veterans. The Social Security Act provides for maternity leave, sick leave, and medical benefits. The old-age pension—Namibia’s most extensive program—provides citizens over the age of 60 with a pension of $45 a month and covers most eligible pensioners. The social safety net is, however, inadequate: there are too few social workers for the size of the population, application procedures for grants are demanding and time-consuming, and the poor are not well targeted.

According to the United Nations, unless Namibia introduces specific growth policies to help the poor, it will have to achieve average real per capita GDP growth of 5½ percent a year to cut poverty in half by 2015. This is significantly higher than the average growth of less than 3 percent a year experienced between 2000 and 2004, and growth is not expected to rise above this rate. Prospective growth alone is clearly too low to enable Namibia to meet the target for poverty reduction.

Income grants

Recently, a coalition of nongovernmental organizations proposed the introduction of a universal income grant under which all Namibians under age 60, regardless of income, would receive a monthly cash grant of $15. This grant, the coalition argues, would reach 93 percent of the population, cost 2½–3½ percent of GDP and be paid for through taxes, move the majority of the population above the poverty line and reduce income inequality, and be less prone to abuse than a targeted grant. Moreover, it would not, according to the coalition, discourage people from looking for work.

However, the IMF staff analysis suggests that the income grant may jeopardize Namibia’s economic stability and compromise its prudent overall fiscal policy stance. The cost of the proposal, according to the analysis, could reach 5½ percent of GDP and require a doubling of the current value-added tax (VAT) rate to 30 percent, assuming that consumption patterns do not change and tax evasion does not increase. Such a large increase in the VAT rate could be highly distortionary, given the narrow tax base. The IMF study indicates that the financing of the grant is likely to offset part of the distributional benefits of the scheme, because VAT taxes typically fall more heavily on poorer households.

In addition, according to the IMF staff analysis, if all citizens are entitled to a cash grant, incentives to have children may be distorted, increasing fertility rates and conflicting with other health policies that Namibia is pursuing. A universal grant may also have an adverse effect on labor markets, with the reservation wage—the wage offered for low-paying jobs in the informal sector—increasing along with the grant amount. Another concern is that communities that depend largely on subsistence farming may use the cash for unproductive consumption (such as alcohol), thereby neutralizing the intended stimulus for local economic activity.

A better solution

Approaches tried elsewhere in the world may offer superior options. The IMF staff study suggests a conditional cash transfer (CCT) program as an alternative to the universal income grant. Starting with Brazil in the 1990s, several Latin American countries have launched such programs. The region’s two largest programs, those of Brazil and Mexico, have been found to help improve the welfare of 15 percent of the population in Latin America.
CCT programs provide cash to poor families conditional on behavior, usually investment in human capital (that is, education, job training, and health), thereby helping prevent both current and future poverty. They address existing poverty by providing income support to smooth consumption and inequity by targeting resources to the poor; they restore efficiency by providing incentives for parents to invest in their children’s health and education. Political support for the programs in Latin America is strong, and administrative costs have been low.

Namibia, with its high incidence of poverty and limited social safety net, appears to be a good candidate for a CCT program, which could help it make progress toward the MDGs. By targeting the two most vulnerable population groups—poor children and HIV-affected individuals—a CCT program could reduce poverty and improve the distribution of income.

Cash grants could be targeted to young children (through the female head of household) and nursing and pregnant women contingent on, for example, visits to health centers, health and nutrition workshops, yearly checkups, and prenatal health care. Separate grants could be targeted to older children (also through the female head of household) who attend school regularly to help them pay school fees, which are prevalent in Namibia.

To reduce poverty among those with HIV/AIDS, Namibia could provide them with cash grants on the condition that they visit a health center regularly. Such grants, which would enable them to eat regularly, would make treatment more effective and would thus benefit society as a whole. This approach would combine an investment in future health with immediate poverty reduction.

The Namibian authorities would do well to consider conditional cash transfers as an alternative to the recent proposal for universal income grants. They would need to think carefully about who the potential beneficiaries should be and what conditions should apply to the transfers. If Namibia introduces a CCT program, the authorities should take into account other grants and streamline other welfare programs to free up resources. Finally, the IMF study recommends that such a program be rolled out gradually so that fiscal costs, quality of services, and targeting can be monitored.

Namibia enjoys macroeconomic stability, needs to tackle poverty and AIDS

According to the IMF’s annual economic review, Namibia has recorded robust growth, falling inflation, a substantial current account surplus, and low external indebtedness over the past two years. But GDP growth slowed in 2005, as diamond production fell, currency appreciation hurt fishing and commercial agriculture, and higher oil prices affected the transportation sector. Inflation moderated in 2004–05, and growth is projected to strengthen in 2006 as diamond production picks up.

Namibia’s current account surplus peaked in 2004 as surging diamond exports and buoyant receipts from the Southern African Customs Union (SACU) offset a large increase in imports, including oil. As for the capital and financial accounts, outflows remained high as financial institutions invested heavily in South African financial markets.

The fiscal deficit for FY2004/05 (April–March) was larger than expected but smaller than a year earlier, partly because of windfall SACU receipts and higher tax revenues. But value-added tax collections were lower than budgeted, owing to administrative problems.

The IMF Executive Board commended the authorities’ prudent macroeconomic policies. Medium-term prospects are promising, the Directors said, if the authorities maintain a stable macroeconomic environment and implement structural reforms to address poverty, unemployment, and HIV/AIDS.

They welcomed Namibia’s reduced fiscal deficit and the commitment to further fiscal consolidation. They reiterated the importance of realistic budgets, efforts to shore up revenues and reprioritize spending, and measures to contain the civil service wage bill, strengthen tax administration, and restructure and/or divest public enterprises. Directors encouraged the authorities to consider new approaches to alleviate poverty, including well-targeted cash grants, if deemed appropriate.

The Directors noted that the Namibian dollar’s peg to the South African rand had anchored macroeconomic policymaking and helped reduce inflation, but reiterated the importance of ensuring adequate levels of international reserves.

The Directors welcomed Namibia’s conclusion of a review under the Financial Sector Assessment Program. They also stressed the need to raise the quality of education, enhance the flexibility of labor markets, further liberalize trade, and improve Namibia’s business climate.
Gabon: preparing fiscal policies for the post-oil era

Gabon's oil revenue currently accounts for 60 percent of its government's total revenue, but the country's oil reserves are expected to be depleted within 30 years. A distant worry? Not really, suggests a background paper prepared for the IMF's annual consultation with Gabon. Adjustment is never easy. Old habits are hard to break, and reaching a sustainable fiscal position will take several years. All the more reason, the paper argues, to plan ahead. The sooner a country implements fiscal adjustment, the better off it will be in the long run.

For oil-producing economies, large (but exhaustible) oil revenues often create the illusion that binding budget constraints have disappeared. Abundant government resources inevitably generate political pressures to spend a larger portion of current income than could be maintained beyond the period of oil production. In addition, excessive spending creates dependencies and vested interests.

How can policymakers gauge their long-term needs? It is useful to have a benchmark against which to judge current fiscal policy. Gabon today runs large overall fiscal surpluses, but the key fiscal indicator—the non-oil fiscal balance—shows a significant deficit. And it is this non-oil balance that offers the crucial measure of how much oil revenue is being injected into the economy and what will need to be done to contain expenditure when oil revenue declines.

Political-economy considerations argue for defining a clear fiscal anchor that can give the legislative branch, and the electorate, a means to distinguish between sound, forward-looking fiscal policies and ones that address only immediate demands. Ideally, of course, such a framework is established at the start of oil production, before habits are formed. But even mature oil exporters have much to gain from pursuing a voluntary, gradual fiscal adjustment that aims to achieve a sustainable deficit and helps preserve national wealth for future generations as well.

Setting the fiscal anchor

While existing models based on the permanent income hypothesis can estimate appropriate long-run targets, they usually abstract from short-run political costs associated with adjustment toward that level. An abrupt, onetime consolidation followed by a constant expenditure path (equal to the expected annuity value of oil wealth and non-oil revenue) is the canonical policy recommendation.

Political reality often precludes such a radical approach, however. It seems more sensible to acknowledge that habits are indeed hard to break (that is, consumers become used to a given level of consumption, including of public goods). Adjustment that incorporates habits can help ease the pain for consumers and increase the political acceptability of the needed reform. For Gabon, the IMF staff used a quantitative model that simulates the non-oil fiscal deficit that can be maintained even after Gabon's oil revenue runs out and describes the optimal adjustment path toward this level. In line with the literature, this path is defined as the one that a social planner would choose. The model also contains differential interest rates on sovereign debt and financial assets, which introduces further realism into the analysis of optimal fiscal policy and debt management.

Policy implications

What guidance does this exercise offer policymakers? Three principal conclusions emerge. First, Gabon's current fiscal policy stance cannot be maintained. The permanently sustainable non-oil fiscal deficit, estimated at about 5 percent of non-oil GDP, is well below the level of 12 percent recorded in 2005. The authorities will need to tighten fiscal policy to smooth government spending over time.

Second, spreading the bulk of the adjustment over three to five years, taking into consideration consumption habits, is appropriate. This recommendation differs from the sharp correction prescribed by permanent-income models. Although the speed of adjustment does influence the long-run fiscal position, this trade-off is relatively small if the adjustment occurs within the medium term.

And, finally, it would be advisable for the government to pay off expensive debt, both domestic and external, as soon as possible. The interest rate spread between sovereign debt and financial assets argues in favor of front-loading fiscal adjustment, thereby increasing the permanently sustainable fiscal deficit. Moreover, still unresolved issues regarding the remuneration of fiscal reserves in the Economic and Monetary Community of Central Africa zone, together with the uncertainty regarding future eco-
nomic conditions, provide policymakers with precautionary motives for balancing the political considerations for gradualism against economic arguments for accelerating fiscal adjustment and transferring a larger portion of oil wealth to future generations. For instance, a reversal of real oil prices to the 2000–05 average of $30 per barrel of oil would reduce the permanently sustainable deficit to 3¾ percent of non-oil GDP.

A choice for the future
At this critical juncture in Gabon’s history, oil prices are high, and the authorities have a choice to make between a voluntary, gradual policy adjustment toward a permanently sustainable fiscal policy stance and a continuation of current policies until the decline in oil production (or unexpectedly falling prices) imposes a large and rapid contraction. If Gabon elects to pursue a proactive adjustment, that process should be accompanied by improvements in the quality of public expenditure so that private investment is crowded in.

Gabon needs to reduce its dependence on oil
In 2005, economic growth in Gabon picked up to almost 3 percent and inflation remained close to zero. Non-oil growth, led by rising timber processing, manganese production, and the services sector, reached 4½ percent. Meanwhile, buoyant international oil prices resulted in continued large balance of payments and fiscal surpluses, allowing a reduction in external debt to 39 percent of GDP at end-2005, the IMF said in its latest economic review of the country.

However, oil reserves are expected to be exhausted in about 30 years, and Gabon will need to reduce its dependence on oil over the medium term.

The IMF Executive Board noted that Gabon’s key policy challenge is to strike a balance between preparing for the exhaustion of oil reserves by raising public savings and dealing with continued pressures for public spending. Most Directors called for an immediate fiscal adjustment that would make significant progress toward a fiscal position that is sustainable over the medium term.

The Directors also underscored the importance of strengthening public expenditure management and, toward that end, called for a more effective prioritization of the public investment program, stronger budget execution and monitoring, improved transparency of the budget—notably of oil revenue—and greater efficiency of the tax system through a broadening of the non-oil revenue base. They also pointed out that costly implicit subsidies on petroleum products that benefited primarily higher-income households were growing rapidly. They encouraged the authorities to reflect these subsidies fully in the government budget and to gradually adjust retail prices toward import parity levels, with well-targeted assistance to the poor.

The Directors commended the authorities for their Growth and Poverty Reduction Strategy Paper but underscored the need to formulate concrete poverty-reducing programs and accelerate the structural reform agenda to stimulate higher growth. In this context, they emphasized the importance of improving the investment climate to foster private sector development. The Directors also noted that further trade liberalization would improve Gabon’s competitiveness, and they urged the authorities to take a leading role in regional discussions with the Economic and Monetary Community of Central Africa in this area.
Mind the gap: is growth leaving some Indian states behind?

There is mounting concern that rapid growth in India is leaving poorer states behind and may increase the proportion of the population living in poverty. What are the implications for India if the rising tide of growth fails to lift all states? A new IMF Working Paper takes a closer look at state-level data and examines which policies have been successful in spurring rapid growth and what poorer states can learn from their neighbors.

Rising income inequality in India is potentially a serious matter. It could lead to social, political, and economic difficulties and erode support for economic reforms and the further opening of the Indian economy. These concerns are deepened when population growth projections are considered. Between 2006 and 2051, about 60 percent of the projected 620 million increase in the Indian population is expected to occur in three of its poorest states (Bihar, Madhya Pradesh, and Uttar Pradesh).

To better gauge the nature and extent of the problem, a new IMF Working Paper explores how growth has varied across India’s 27 largest states over the past three decades. It finds evidence of a widening income gap between rich and poor states (see chart). The ratio of average per capita income in India’s richest state, Punjab, to that in its poorest state, Bihar, rose to 4.5 percent in 2004, from 3.4 percent in 1970. The pace of growth in real per capita income in India’s fastest-growing states—just over 3 percent a year—has been more than twice as fast as that in the slower-growing poor states.

Sharp contrasts
There are also stark differences across states in how growth has translated into poverty reduction and job creation. On average, richer states have been about 50 percent more effective in reducing poverty, for each percentage point of growth, than poorer states. The pace of job creation in middle- and high-income states has far outstripped that in poorer states. India’s poorest and most populous states account for about 40 percent of the population but capture only one-fourth of jobs in the organized sector.

One might also expect that capital and jobs—attracted by a pool of low-paid or unemployed workers—tend to move to poorer states. This has not occurred, however. About 55 percent of outstanding bank loans in India in FY2004/05 were to borrowers in the five richest states, whereas borrowers in the five poorest states accounted for a mere 15 percent. Moreover, over half of the foreign direct investment inflows into India in recent years have gone to five largely prosperous states.

Another possible mechanism tending to reduce disparities in incomes across states would be labor migration from poorer to richer states. In fact, labor in India does migrate to the richer states, but labor mobility across state borders is very low by international standards and does little to assist the convergence process. Only 6 percent of migration in rural areas and 20 percent of migration in urban areas in recent years has occurred across state borders.

But surprises, too
Closer examination of economic performance at the state level, however, uncovers interesting exceptions to these trends. Some of the fast-growing states rank among the least successful in reducing poverty and generating jobs, whereas some slower-growing states have had immense success in improving living standards. Take, for example, one of India’s richest and fastest-growing states, Maharashtra (which includes the financial capital of India, Mumbai). It was less successful in translating its growth into jobs and poverty reduction over the past three decades than Rajasthan, which grew much more slowly than the national average (see table).
This all suggests that differences in policies across states could have important ramifications for economic performance. Indeed, other studies have found that states that have sought to liberalize factor markets and promote good institutions have fared better than others. For example, research by Timothy Besley and Robin Burgess in 2000 found that states that amended labor laws in favor of workers experienced lower growth in output, employment, investment, and productivity in the formal manufacturing sector and increases in urban poverty. Using district-level data, Abhijit Banerjee and Lakshmi Iyer in 2005 found that areas in which proprietary land rights were historically given to landlords had significantly lower agricultural investment and productivity after independence than areas in which these rights were given to cultivators.

**Policies matter**

An empirical analysis of the drivers of real income growth across states between FY1973/74 and FY2002/03 finds that the economic policies adopted by states influence their subsequent growth performance. In common with much of the literature on the subject, the Working Paper found evidence that poor states grew faster than rich states once controls that proxy for differences in the policies and economic structure across states were held constant.

The rate at which the gap in incomes between poor and rich states closes—about 1–2 percent a year—is very slow, however. This implies that it can take anywhere between 44 and 62 years to close half the gap between any state’s initial level of per capita income and its long-run steady-state level. This is disheartening in that it suggests that a large part of the differences in state income levels reflects differences in their long-run income potential.

But the news is not all bad. The types of economic policies states adopt can have long-run growth effects. Greater investment—proxied by the stock of real private credit per capita—can lead to faster economic growth over a number of years.

The quality of a state’s infrastructure also appears to have been an important determinant of growth. Taking the level of technical and distribution losses in the electricity sector as a proxy for the quality of a state’s infrastructure network and the strength of its institutions, the analysis finds that states with smaller losses—that is, better infrastructure and institutions—have experienced faster growth.

The size of government also matters: states with leaner and smaller governments have generally grown faster than relatively high-spending ones. States with a greater initial dependence on agriculture and/or industry also grew more slowly than states in which services played a larger role. Interestingly, the analysis does not find robust evidence of the effects of labor regulations and education on growth, owing to shortcomings in the measurement of these policy variables.

What does all this mean? While growth has so far resulted in widening disparities in average per capita incomes across India’s states, the findings indicate that states can take actions to correct this and that the future need not repeat the past. By adopting better economic policies, states can improve their relative growth performance. They can enhance their long-run economic position by raising investment, improving infrastructure, and pursuing sound fiscal policies. There is also a need, particularly in the poorly performing states, to diversify the economic production base away from agriculture and industry or to adopt policies that make these sectors more productive.

**Growth and poverty**

Some fast-growing states have not made strong progress in reducing poverty.

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<td>Low poverty elasticity</td>
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¹Using gross state domestic product. Most recent poverty data available are from 2001. Data: IMF staff estimates.

This article is based on IMF Working Paper No. 06/103, “Mind the Gap: Is Economic Growth in India Leaving Some States Behind?” by Catriona Purfield. Copies are available for $15.00 each from IMF Publication Services. Please see page 192 for ordering details. The full text is also available on the IMF’s website (www.imf.org).
Economic development is associated with broad improvements in health standards. For example, higher income facilitates improvements in health services, and improved nutrition translates into better health and higher productivity. Analyzing the implications of the HIV/AIDS pandemic in four sub-Saharan African countries, a new IMF Working Paper finds that the disease affects households unevenly and has significant implications for poverty and inequality.

To understand the economic implications and policy challenges associated with a health crisis such as HIV/AIDS, it is important to address its microeconomic effects, as well as its macroeconomic and fiscal consequences. Increased morbidity, or mortality, reduces living standards directly and also implies risks to material living standards associated with medical expenses, the loss of income, and reduced access to education.

Lost income
To examine these issues, the study uses data from household expenditure surveys and demographic and health studies to simulate the impact of HIV/AIDS on poverty and inequality in Ghana, Kenya, Swaziland, and Zambia. With mortality stemming from HIV/AIDS concentrated among the working-age population, it is the income-earning members of a household who are most likely to die (see top table). Yet the death of an economically active person also means that jobs and business opportunities arise for others. Thus, although some households lose family members (and income), others may benefit by finding employment.

Even if HIV/AIDS has only a small effect on GDP per capita, the study finds that it can nonetheless have a substantial impact on poverty for two main reasons. First, higher mortality increases mobility (both upward and downward) in income distribution; overall, this translates into a rise in inequality. Second, HIV prevalence tends to be high in households vulnerable to falling into poverty, thereby exacerbating the impact of HIV/AIDS on poverty beyond what would be expected from any changes in average per capita income.

Moreover, the findings underscore the importance of analyzing the socioeconomic profile of the epidemic. For example, controlling for the level of HIV prevalence, the impact of HIV/AIDS on poverty rates appears much stronger in Ghana than in the other countries considered, reflecting both a higher share of the population at risk of falling into poverty and relatively high HIV prevalence rates for this population group (see bottom table).

Overall, the study finds that, because the impact of HIV/AIDS is very uneven across households, the epidemic has substantial implications for the extent of poverty and inequality. A broad macroeconomic assessment of the impact of HIV/AIDS (or any other health crisis), focusing on GDP per capita, masks those distributional aspects and thus fails to capture many of its welfare effects.

Markus Haacker
IMF African Department

This article is based on IMF Working Paper No. 06/126, “HIV/AIDS: The Impact on Poverty and Inequality,” by Gonzalo Salinas and Markus Haacker. Copies are available for $15.00 each from IMF Publication Services; see page 192 for ordering details. The full text is also available on the IMF’s website (www.imf.org).
Stand-By, EFF, and PRGF arrangements as of May 31, 2006

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EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Finance Department.
China and India: sizing up two giants

China and India are the star growth performers among the world’s major economies and, as the IMF’s Wanda Tseng pointed out at a May 18 book forum hosted by the IMF Institute, “barely a week goes by without an article or a discussion in an international publication about their reform experience, economic performance, and future prospects.”

It is easy to think of the two emerging market powerhouses as more or less similar. Are they? Tseng moderated a panel discussion on a new book she coedited with David Cowen (IMF), India’s and China’s Recent Experience with Reform and Growth. The panelists were Jerald Schiff (IMF), Nicholas Lardy (Institute for International Economics), and Arvind Panagariya (Columbia University).

A major difference in scale

According to Lardy, when most people talk about China and India today, they are missing a sense of the significant difference in scale between the two countries (see table). The two countries are converging in terms of their rates of economic growth because India’s growth has accelerated dramatically in the past 10 years, but China is still “a much bigger economy than India,” he said.

Schiff cautioned, however, that any China-India comparison needs to be put into perspective. A contrast with China “sets the bar very high for India,” but any country that achieved the kind of takeoff in both services and manufacturing that India has would be impressive by any non-China standard.

Is politics a factor?

Bhabani P. Misra, IMF Executive Director for India, Sri Lanka, Bangladesh, and Bhutan, concurred that China’s economy had experienced “fantastic development by any yardstick.” He said that studies comparing the economic performance of India and China do not seem to have adequately analyzed the role played by India’s democratic system of government—with its dialogue, debate, and consensus building—in the relative speed and nature of growth. He wondered if this could be a significant factor in the striking differences in the relative performance of India and China.

Lardy, suggesting there had been “much more change in the nature of governance in China than is commonly recognized,” cited an early 1990s administrative law allowing citizens to sue the government. Indeed, thousands have subsequently sued, won, and received compensation, he said.

Has politics been a factor in India’s relatively slower growth? Does development take longer in a democracy? Panagariya underscored that it takes longer to build consensus and introduce new policies in India. He argued, however, that “it is worth having democracy.” The future, he said, will show the extent to which “the PC [personal computer] and the CP [communist party] will come together and be compatible.”

In the long run, Panagariya said, China will have to transition to democracy, and India may come out ahead. He also warned against overemphasizing the inconsistencies of India’s political regime. India has brought about slow reforms and done well, he said, and should now focus on policies that are politically feasible.

Ina Kota
IMF External Relations Department

A difference even among giants

China’s economy is three times larger than India’s and contributes significantly more to global economic growth.

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<td>$0.617 tr</td>
<td>$0.356 tr</td>
<td>$0.207 tr</td>
</tr>
<tr>
<td>Foreign exchange services$3</td>
<td>15%</td>
<td>15%</td>
<td>7%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Contribution to global growth$4</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>National savings rate$5</td>
<td>41%</td>
<td>41%</td>
<td>41%</td>
<td>41%</td>
<td>41%</td>
<td>41%</td>
<td>41%</td>
</tr>
<tr>
<td>Adult female literacy rate$6</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
<td>87%</td>
</tr>
<tr>
<td>Investment in infrastructure$7</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Investment in foreign direct investment$8</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
</tr>
</tbody>
</table>

$1Figures are for 2005.
$2Figures are for 2000–04.
$3Figures are for 2004.
Data: Chinese and Indian authorities; Economist Intelligence Unit; Goldman Sachs; and UNESCO Institute for Statistics.