INTERNATIONAL MONETARY FUND

IMF POLICY PAPER

MACROECONOMIC DEVELOPMENTS AND PROSPECTS IN LOW-INCOME COUNTRIES – 2026

March 2026

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 18, 2026, consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on February 18, 2026, for the Executive Board's consideration on March 18, 2026.
- A **Staff Supplement**. Readers who are interested in the impact of the war in the Middle East on Low-Income Countries' economies should refer to this **supplement** that reports on these developments and information that became available after the report was issued to the Board on February 19, 2026.

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR26/097

Press Release – Macroeconomic Developments and Prospects in Low-Income Countries—2026

FOR IMMEDIATE RELEASE

Washington, DC – March 31, 2026: On March 18, 2026, the Executive Board of the International Monetary Fund (IMF) discussed the IMF staff paper on Macroeconomic Developments and Prospects in Low-income Countries (LICs). The paper defines LICs as the 70 countries eligible for the Poverty Reduction and Growth Trust facilities.[1]

LICs are navigating a fluid global environment marked by high uncertainty and shifting policies in major economies spanning trade, migration, digital finance, and spending priorities, including national security and foreign aid. The spillovers of the ongoing conflict in the Middle East adds to the pressures, although the actual impact will depend on the duration of the conflict and breadth of disruptions.

While internal and external imbalances have been narrowing in recent years, macroeconomic outcomes remain highly divergent across LICs. GDP growth averaged 4.8 percent in 2025, but remained highly heterogenous across LICs. Some LICs are among the world's fastest growing economies, while others grow insufficiently to boost per capita income. Inflation continues to ease but hotspots remain. Fiscal consolidation has supported modest reductions in public debt, yet debt vulnerabilities remain high, and the significant increase in domestic borrowing is raising new concerns. Many LICs with thin foreign exchange reserves remain vulnerable to changes in commodity prices, global interest rates, and further aid cuts. Divergence across LICs is expected to persist over the medium term amid elevated global and domestic risks.

External financing to LICs is undergoing major shifts. After peaking during 2010-14, net financial inflows to LICs have fallen by about one third amid declines in FDI equity flows and external debt. New public sector borrowing from the private sector has been contracted at higher interest rates and shorter maturities, while official creditors have adjusted terms more gradually, preserving grant element for the poorest LICs. Official Development Assistance flows have declined in recent years to 4.3 percent of LIC GDP, from an average of 5 percent during 2010-14, and are projected to continue falling, alongside shifts from grants to loans and from budget support to project financing. While remittance inflows to LICs have been increasing, ongoing changes in immigration policies globally pose risks to remittance flows.

The report also highlights that stronger fiscal discipline and fiscal institutions, particularly revenue administration and public financial management, are associated with higher Foreign Direct Investment (FDI) inflows in LICs, with the effects that are stronger in LICs than in emerging markets and amplified in high-uncertainty settings. Stronger fiscal institutions are also linked to higher quality FDI, proxied by R&D intensity. When fiscal discipline, fiscal institutions, and broader institutional settings are considered jointly, fiscal institutions emerge

[1] The list can be found in Annex I of the report.

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as a more important institutional correlate of FDI to LICs. Meanwhile, commonly used fiscal incentives such as tax reductions or special economic zones appear to attract FDI only where fiscal discipline and institutions are strong.

Navigating global uncertainties and external financing shifts calls for resolute domestic policies and reforms and adequate support from international partners. Domestic policy and reform efforts will be critical to increase returns on capital and attract stronger FDI inflows. Given their scarcity, concessional resources should be more strongly prioritized toward poorer and fragile LICs. Targeted capacity development and enhanced coordination between LIC authorities and development partners would boost reform implementation and help reduce borrowing costs. The IMF has a strong role to play in supporting these efforts through its policy advice, capacity development, and lending where needed.

Executive Board Assessment[2]

Executive Directors welcomed the opportunity to discuss recent macroeconomic developments and prospects in low-income countries (LICs). They broadly supported staff's assessment and the identified policy priorities, in particular the need to support macroeconomic and financial stability, reinvigorate growth, and reduce high debt burdens.

Directors acknowledged that LICs are navigating a highly uncertain global environment, amid conflicts and geopolitical tensions, including the ongoing conflict in the Middle East, and policy shifts in major economies. They welcomed the narrowing of internal and external imbalances and easing inflation across LICs and that growth is expected to remain resilient. Directors, nonetheless, recognized the significant divergence in macroeconomic outcomes, particularly the strong and steady growth achieved by LICs with diversified manufacturing and services exports, and the weaker economic performance in many LICs experiencing conflicts and fragility, where growth remains insufficient to generate meaningful gains in per capita income. While welcoming the modest decrease in LICs' public debt levels, Directors expressed concerns that elevated debt service burdens continue to limit space for development spending in many countries. They highlighted that tighter external conditions have accelerated a shift toward domestic borrowing, raising concerns about sovereign-bank linkages and related financial stability risks.

Looking forward, Directors considered that divergence across LICs would persist over the medium term. They expressed concerns about substantial downside risks, amid continued global uncertainty and potential domestic shocks that could disrupt economic activity and set back development gains in LICs. Against this background, they underlined that continued contributions from, and coordination between, the World Bank and Fund to support economic diversification and transformation, including through enhanced focus of their existing toolkit on this agenda, will be key to achieving strong and inclusive growth, while strengthening resilience.

Directors highlighted the importance of remittances and official development assistance (ODA), particularly in the poorest LICs. They expressed concern about declining ODA,

[2] An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

changes in aid composition, and the impact of shifting immigration policies on remittances. Directors agreed that the channeling of scarce concessional resources should prioritize the poorest countries and fragile LICs with limited market access. Noting the ongoing shift in ODA from budget support to project financing and from grants to loans, Directors emphasized the importance of strong public financial management (PFM), coordination with donors, and country ownership.

Directors noted the major shifts in the level and composition of external financing to LICs and expressed concern about weaker FDI equity inflows and external debt flows. They agreed that subdued capital flows to LICs may be linked to a widening marginal product of capital gap relative to advanced economies.

Directors agreed that stronger domestic policies and reforms are critical to increase returns on capital and attract stronger FDI inflows. This includes policies to enhance macro-financial stability and maintain price stability, as well as accelerated structural reforms to enhance resilience, policy credibility, and private sector-led growth and job creation. Directors recommended that fiscal structural reforms be focused on mobilizing domestic revenue, safeguarding priority development spending, and enhancing transparency and governance. They also emphasized the importance of the Fund and World Bank's 3-pillar approach to help LICs with a strong reform agenda and sustainable debt, faced with short-term financing challenges, and underscored the need to strengthen PFM and debt management practices.

Directors welcomed the empirical analysis of fiscal policy and institutional drivers of FDI to LICs. They expressed concern that FDI inflows to LICs remain limited and concentrated in low R&D-intensive and less job-creating sectors. Directors recognized the importance of stronger fiscal discipline and institutions, particularly in revenue administration and PFM, in increasing FDI inflows, with the effects stronger in LICs than in emerging markets and in high-uncertainty settings. Stronger fiscal institutions are also associated with higher quality FDI, measured by the extent to which investments involve R&D. Directors also highlighted the need for cautious use of fiscal incentives, such as tax cuts or special economic zones, particularly in the absence of strong fiscal discipline and institutions.

Directors underscored the importance of strong and sustained Fund engagement with LICs, through tailored policy advice, capacity building, and financing, in close coordination with the World Bank and other development partners. They looked forward to further discussions on Fund engagement with LICs and fragile and conflict-affected states, including in the context of the Comprehensive Surveillance Review, Review of Program Design and Conditionality, and Review of the Debt Sustainability Framework for LICs (LIC DSF).

INTERNATIONAL MONETARY FUND

February 18, 2026

MACROECONOMIC DEVELOPMENTS AND PROSPECTS IN LOW-INCOME COUNTRIES – 2026

EXECUTIVE SUMMARY

Low-income countries (LICs) are navigating a fluid global environment marked by high uncertainty and shifting policies in major economies. Persistently high uncertainty and policy shifts on trade, migration, digital finance, and spending priorities, including national security and foreign aid, are impacting LICs directly or indirectly. Cuts in official development assistance (ODA) have already affected LICs, while ongoing restrictions in immigration policies are expected to impact remittances going forward. Conversely, most LICs have benefited in recent months from lower food and energy prices and a weaker dollar, all having slightly eased balance of payments pressures.

Macroeconomic outcomes continue to be highly divergent across LICs. Average GDP growth—projected to accelerate from 4.8 percent in 2025 to 5.3 percent in 2026—remains heterogeneous across LICs, with some countries among the world's fastest-growing while, for a number of others, growth remains insufficient to secure meaningful gains in per capita income. Inflation continues to ease but hotspots remain. Gradual fiscal consolidation has supported modest reductions in public debt levels, yet high debt service burdens constrain space for development spending. Tighter external borrowing conditions for LICs have accelerated a shift toward domestic borrowing, deepening sovereign-bank linkages and related financial stability risks. Despite significant improvements, foreign exchange reserves remain thin in many LICs, leaving them vulnerable to changes in commodity prices, global interest rates, and aid cuts.

External financing to LICs is undergoing major shifts. Risks of near-term declines in remittances are growing, while ODA envelopes are projected to shrink as donors reassess spending and policy priorities and tilt support toward loan- and project-based financing. FDI equity inflows and, more recently, external debt flows are below pre-COVID levels. This report's analysis suggests that subdued international capital flows to LICs are linked to a widening gap in the marginal product of capital between LICs and advanced economies, particularly for public capital, calling for appropriate actions.

Given FDI's growth-enhancing role, this report analyzes the fiscal policy and institutional drivers of FDI. Despite substantial development needs, LICs continue to receive less than 1 percent of global FDI, broadly in line with their share of global GDP, with inflows increasingly concentrated in low R&D intensive and less job-creating sectors—such as energy and extractive industries. Using gravity and local-projections

models, Section II documents four key findings. First, fiscal discipline and fiscal institutions—particularly revenue administration and public financial management (PFM)—are positively associated with FDI inflows in LICs, with effects that are stronger in LICs than in emerging markets (EMs) and amplified in high-uncertainty settings. Second, stronger fiscal institutions are also associated with higher-quality of FDI, proxied by R&D-intensity. Third, when fiscal discipline, fiscal institutions, and broader institutional quality are considered jointly, fiscal institutions emerge as more important institutional correlate of FDI. Fourth, fiscal incentives—such as tax cuts or special economic zones (SEZs)—are only associated with higher FDI where fiscal discipline and fiscal institutions are strong; they appear ineffective otherwise.

Navigating global uncertainties and external financing shifts calls for resolute domestic policies and reforms and adequate support from international partners.

- Continued fiscal consolidation will be necessary in most LICs, including through domestic revenue mobilization and prioritization of spending, along with strengthening public financial management and debt management, with a calibration and pace depending on each country's circumstances. Greater scrutiny of public sector borrowing—especially on non-concessional terms—will be essential to preserving debt sustainability. Monetary and exchange rate policies must continue to focus on price stability while safeguarding financial stability. In addition, structural reforms conducive to private sector-led growth and job creation must be accelerated. While challenging, targeted governance reforms aimed at combating corruption and improving the effectiveness of government institutions and central banks will also be fundamental. These policies and reforms will underpin macroeconomic stability and build up buffers. They will also raise investment returns in LICs, fostering growth-enhancing FDI.

- Focusing on FDI, strengthening macro-fiscal management—through credible medium-term frameworks, attention to debt sustainability and buffers, and stronger macro-fiscal analytical capacity—can improve investors' risk-adjusted returns by reducing macroeconomic volatility and policy uncertainty. Reinforcing fiscal institutions further supports investor confidence by limiting discretion and governance risks. Fiscal incentives should be used selectively and subject to careful ex-ante assessment. SEZs warrant particular caution, as they can entail significant fiscal costs, encourage resource misallocation and rent-seeking, and yield limited additional investment in the absence of strong governance, administrative capacity, and integration with the broader economy. Given capacity constraints, reform sequencing matters: macro-fiscal credibility and institutional strengthening should precede the use of more targeted fiscal policy tools.

International support, including from the IMF, will be critical to accelerating these reforms. Scarce concessional resources from bilateral and multilateral partners should be prioritized toward poorer and fragile LICs, as more advanced LICs can rely more on market financing. Targeted capacity development and enhanced coordination between LIC authorities and their development partners would boost reform implementation, which in turn, would help reduce borrowing costs. The IMF has a strong role to play in supporting these efforts through its policy advice, capacity development, and lending where needed.

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Glossary

AE	Advanced Economy
AGOA	African Growth and Opportunity Act
AI	Artificial Intelligence
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
BOP	Balance of Payments
CA	Current Account
CD	Capacity Development
CIT	Corporate Income Tax
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee
DSA	Debt Sustainability Assessment
DSF	Debt Sustainability Framework
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EM	Emerging Market
EMBIG	Emerging Market Bond Index Global
EMDE	Emerging Market and Developing Economies
ESA	External Sector Assessment
FAD	Fiscal Affairs Department
FCS	Fragile and Conflict-affected States
FDI	Foreign Direct Investment
FM	Frontier Market
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GFN	Gross Financing Need
GFC	Global Financial Crisis
GNI	Gross National Income
GovTech	Government Technology
GRA	General Resource Account
GSDR	Global Sovereign Debt Roundtable
HELP	Haitian Economic Lift Program
HOPE	Haitian Hemispheric Opportunity through Partnership Encouragement
ICT	Information and Communication Technology
IDA	International Development Association

IDS	International Debt Statistics
IFS	International Financial Statistics
IQR	Interquartile Range
ISORA	International Survey on Revenue Administration
LICs	Low-income Countries
LP	Local Projection
MPK	Marginal Product of Capital
NGO	Non-governmental Organization
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PCA	Principal Component Analysis
PFM	Public Financial Management
PI	Portfolio Inflow
PIM	Public Investment Management
PNG	Private Non-Guaranteed
PPG	Public and Publicly Guaranteed
PPML	Poisson Pseudo–Maximum Likelihood
PPP	Purchasing Power Parity
PRGT	Poverty Reduction and Growth Trust
REO	Regional Economic Outlook
R&D	Research and Development
RSF	Resilience and Sustainability Facility
SDR	Special Drawing Rights
SDS	Small Developing States
SEZs	Special Economic Zones
SOE	State-owned Enterprise
SPR	Strategy, Policy and Review Department
SSA	Sub-Saharan Africa
TA	Technical Assistance
TFP	Total factor productivity
TOSSD	Total Official Support for Sustainable Development
TSA	Treasury Single Account
VIX	CBOE Volatility Index
WAEMU	West African Economic and Monetary Union
WB	World Bank
WEO	World Economic Outlook
WGI	Worldwide Governance Indicators

SECTION I: NAVIGATING GLOBAL CHALLENGES AND SHIFTS IN EXTERNAL FINANCING

RECENT DEVELOPMENTS AND OUTLOOK IN LICS[1]

A. A Challenging Global Context

1. Sweeping policy shifts in major economies continue to reshape the global environment. The global economy is undergoing a profound transformation. Policy shifts across major economies—spanning trade, migration, digital finance, and spending priorities, including national security and foreign aid—are reconfiguring global markets and redefining policy frameworks, with persistently high uncertainty.

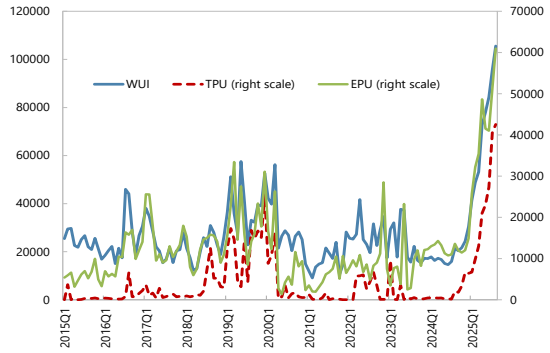
2. Global growth holds but remains subdued with important downside risks. Global growth is projected to remain at 3.3 percent in 2026, broadly in line with the estimates for 2025 and with the 2024 outturn, but marking a downward revision relative to the forecasts made prior to the above-mentioned policy shifts. Risks to the outlook remain tilted to the downside. These include outbursts of trade tensions, lower than expected gains from artificial intelligence (AI) leading to a decline in investment and abrupt financial market correction, and domestic political tensions or geopolitical tensions fueling further uncertainties and weighing on financial markets, supply chains and commodity prices. On the upside, sustained easing of trade tensions, and faster productivity growth stemming from AI would support economic dynamism.

3. Low-income Countries (LICs) are impacted both directly and indirectly by this global context, with important differences across countries. LICs are negatively affected by cuts in official development assistance (ODA), and can expect a negative impact on remittances from restrictions in immigration policies. Conversely, they have generally benefited from the decline in food and energy prices, and from a weaker dollar that has facilitated the repayment of external debt obligations in recent months. However, conditions differ significantly across LICs, depending on the structure of their economies. While exporters of gold and some critical minerals benefit from high prices, fossil fuel exporters and countries largely dependent on ODA face a more challenging context. The direct effect from changes in trade policies on most LICs has been modest thus far (Box 1). For all LICs, external financing costs continue to be elevated, despite narrower spreads, as benchmark interest rates remain above pre-pandemic levels (Figure 1).

[1] Low-income countries are defined in this report as the 70 countries eligible for the Poverty Reduction and Growth Trust (PRGT) facilities. This group can further be divided by income level, institutional characteristics, and export structure, to highlight the significant heterogeneity within the group (Annex I).

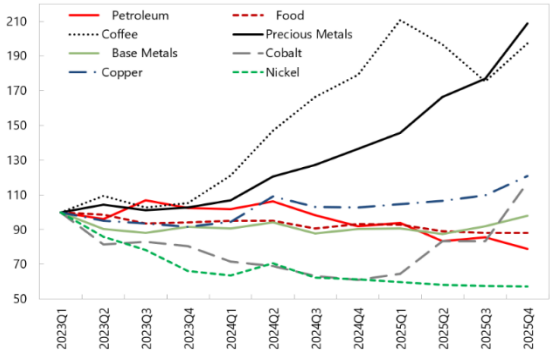
Figure 1. Global Backdrop

Global Policy Uncertainties 1/
(Index)



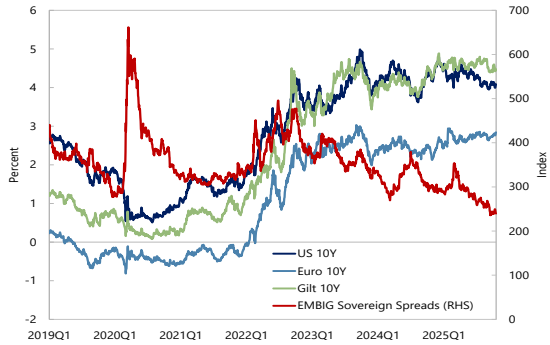
Sources: Ahir, Bloom, and Furceri 2022, IMF staff calculations.

Global Commodity Prices
(Index, 1Q2023=100)



Sources: WEO, IMF staff calculations.

Benchmark Yields and EMBIG Sovereign Spreads



Sources: Bloomberg Finance L.P., European Central Bank.

International Value of the US Dollar
(Index) 2/

Sources: Bloomberg Finance L.P.

1/ The uncertainty measures are news- and media-outlet-based indices that quantify media attention to global news related to overall uncertainty (WUI), economic policy uncertainty (EPU), and trade policy uncertainty (TPU).
2/ DXY is the US dollar index which indicates the general international value of the dollar.

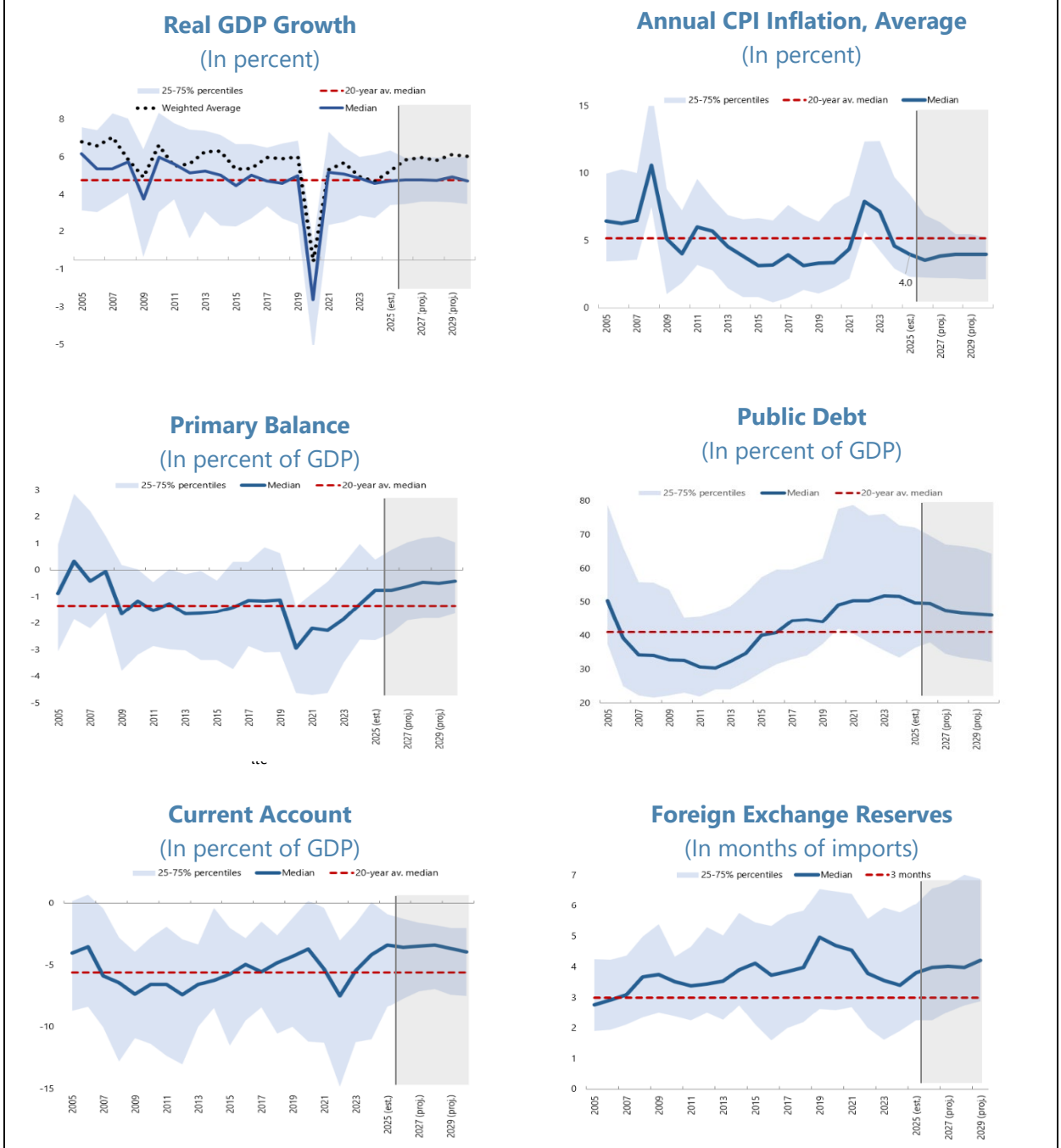
B. Macroeconomic Outcomes in LICs Remain Highly Uneven

Resilient Growth in LICs That Varies Across Countries

4. Generally resilient growth in LICs is expected to continue but outcomes vary substantially across countries. Average weighted GDP growth in LICs is projected to accelerate from 4.2 percent in 2024 to 4.8 percent in 2025 and 5.3 percent in 2026—driven by developments in the largest LICs such as Bangladesh, Kenya, and Uzbekistan. Median growth, however, is significantly

lower and projected to remain stable—4.2 percent in 2025 and 4.3 percent in 2026—pointing to a widening gap between faster- and slower-growing LICs (Text Table 1, Figures 2, 3, 4).[2,3]

Figure 2. LICs: Macroeconomic Outturns and Prospects



Sources: WEO, IMF staff calculations.

[2] Based on average real GDP growth over 2024-2025, six out of the top ten world's fastest-growing economies are LICs—Benin, Ethiopia, Kyrgyz Republic, Niger, Rwanda, and Tajikistan.

[3] Here and below, references to the WEO as a data source refer to the January 2026 WEO vintage.

5. Key drivers of growth differentiation have included:

- **Domestic policy efforts.** Stabilization efforts and steady implementation of sound macroeconomic policies and structural reforms are supporting growth in countries such as Ethiopia, Ghana, Tanzania, and Uzbekistan. Countries such as Rwanda and Tajikistan also benefited from large public and public-private partnership infrastructure projects.

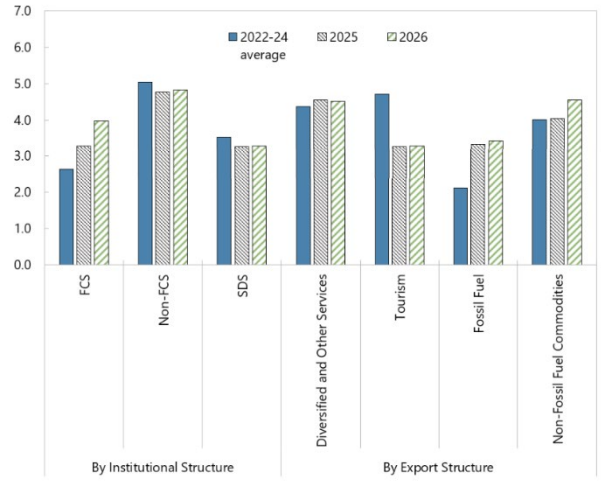
Table 1. Real GDP Growth by Income Group
(In percent, weighted average vs. median)

		2024	2025	2026
AEs	Weighted Avg	1.8	1.7	1.8
	Median	1.7	1.4	1.9
EMs	Weighted Avg	4.3	4.3	4.0
	Median	3.4	2.9	3.2
LICs	Weighted Avg	4.2	4.8	5.3
	Median	4.1	4.2	4.3

Sources: WEO, IMF staff calculations.

- **Export structure.** LICs with diversified manufacturing and services exports maintain strong and steady growth. Separately, many non-fossil fuel commodity exporters are benefiting from higher prices for key metals, including gold (Burkina Faso, Ghana, Mali, Guinea), copper and cobalt (Democratic Republic of the Congo, Zambia)—both of which are critical inputs for AI-related infrastructure—and coffee (Uganda). Median growth of fossil fuel exporting LICs lags behind amid low oil prices, although some of them (Chad, Republic of Congo) are investing to expand medium-term oil and natural gas production while also continuing to diversify their economies. South Sudan's oil production rebounded, recording nearly 25 percent growth in 2025, following the normalization of oil transit through Sudan. Tourism-dependent economies, such as the LICs in the Eastern Caribbean, are adversely affected by cautious global consumer spending on travel amid wide-ranging uncertainties.

Figure 3. Real GDP Growth
(In percent, median)



Sources: WEO, IMF staff calculations.

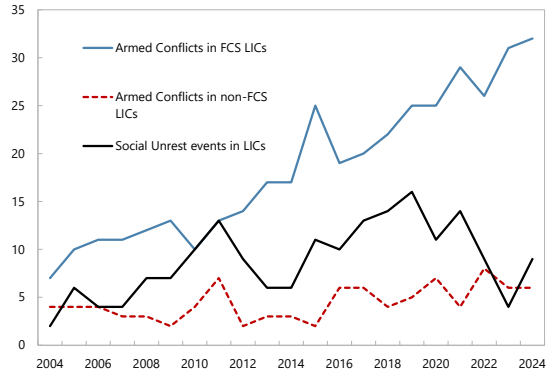
- **Institutional stability vs conflicts and fragility.** Despite some acceleration in 2025, growth in Fragile and Conflict-affected States (FCS) remains below the LIC median, and is even negative in countries such as Haiti, Myanmar, and Yemen (Figure 2, 3).

6. Divergence across LICs is expected to persist over the medium term while spillovers from global risks loom. Assuming sustained policy and reform efforts, median growth in LICs is projected to reach 4.5 percent in the medium term—consistent with its 20-year average. About a third of LICs are projected to grow above 5 percent, led by exporters of manufactured products and

non-oil commodities. At the other end of the spectrum, a quarter of LICs (primarily FCS and SDS[4]) are expected to grow by less than 3.3 percent due to fragility and an undiversified export structure (i.e., dependence on tourism or fossil fuels). Realization of downside risks to the global outlook could weigh on LICs' long-term growth, including by limiting export opportunities, foreign direct investment (FDI), access to technology (via supply chain fragmentation) and related productivity gains. LICs are also particularly vulnerable to domestic shocks—including climate-related events and other natural disasters, episodes of social unrest, armed conflict (Figure 4), and political instability—that can disrupt economic activity and set back development gains.

Figure 4. Social Unrest Events and Armed Conflicts in LICs

(Number of events)



Sources: WUI (social unrest events), Uppsala Conflict Data Program, IMF staff calculations.

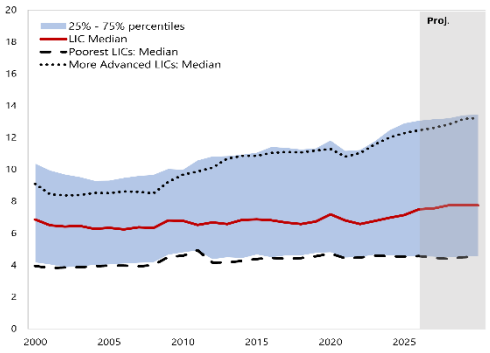
7. For a number of LICs, especially among the poorest, growth rates remain insufficient to generate meaningful progress in per capita income. Over the past 25 years, per capita GDP growth in countries currently assessed as part of the poorest LICs has averaged 1.9 percent, around half a percentage point below more advanced LICs (Figure 5). The difference in GDP per capita growth between the FCS and frontier markets has been even starker. Importantly, some LICs which ranked among the poorest LICs 25 years ago have improved income status (e.g., Moldova) and others progressed even further and graduated from LICs to EMs (e.g., Angola, Vietnam). In addition, several countries that remain among the poorest LICs are now among the world's fastest-growing economies (e.g., Ethiopia, Niger, Rwanda). Nevertheless, for many of today' poorest LICs, rapid population growth, projected at about 2 percent—more than twice as high as in EMs and five times that of AEs[5]—requires sustained higher growth and job creation to secure progress in per capita income. In many of these countries, employment growth has not kept pace with labor force expansion, contributing to higher unemployment and informality, which is weighing on productivity and slowing convergence.

[4] Eight out of 19 LIC SDS are FCS (Annex I).

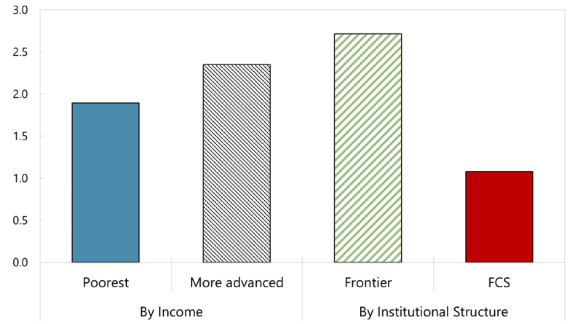
[5] The difference is largely driven by African LICs, where population growth is projected at 2.6 percent, compared to 1.2 percent in other LICs.

Figure 5. Real GDP per Capita in LICs

Real GDP Per Capita in LICs: 2000-30
(Percent of AE median, PPP adjusted)



Real GDP per Capita Growth in LICs
(Averages, 2000-2025, PPP-adjusted)



Sources: WEO and IMF staff calculations. The group of poorest LICs reflects current classification (see Annex I).

Broad Disinflation Continues With a Few Remaining Hotspots

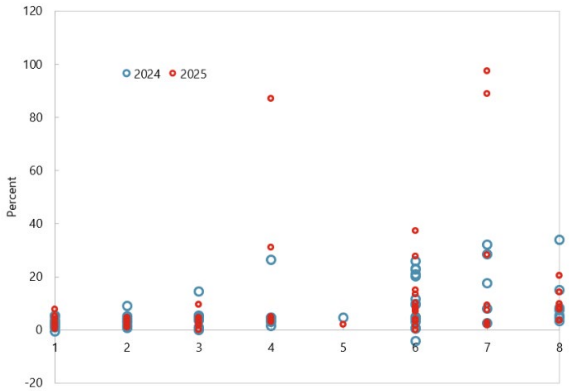
8. Inflation continues to ease in LICs, often supported by domestic policies. The disinflation trend observed since inflation peaked in 2022 is expected to progress further, with median inflation declining from 4.0 percent in 2025 to 3.7 percent in 2026. External factors, such as broad-based declines in global food and energy prices, combined with a weaker US dollar, are reducing import costs. LICs with hard pegs or well-established inflation-targeting frameworks characterized by credible nominal anchors generally recorded lower inflation (Figure 6).[6] Tight monetary policy settings in some countries reinforced the disinflation process. For instance, over half the African Union LICs maintained a contractionary monetary policy stance in 2025. Accordingly, credit growth to the private sector remained subdued (Figure 7).

9. With a view to sustaining progress in lowering inflation, some LICs strengthened their monetary policy frameworks and central bank governance. Ghana enhanced liquidity operations by expanding open market instruments and adopting transparent FX auctions while maintaining a tight stance to re-anchor inflation expectations. Zambia continued implementing a forward-looking interest-rate–based framework underpinned by a new central bank law that reinforced the central bank's operational independence. The Democratic Republic of the Congo introduced a permanent standing lending facility and adopted a new FX intervention strategy to allow greater exchange rate flexibility, while Liberia operationalized a new interest rate corridor and improved its liquidity management through open market operations and expanded collateral frameworks. Ethiopia transitioned to an interest rate-based monetary policy while liberalizing the FX market. Following exchange rate depreciation, tight fiscal and monetary policies contributed to cutting inflation in Ethiopia by a third.

[6] Macroeconomic Developments and Prospects in Low-Income Countries, 2025, paragraph 29, discusses the interplay between monetary and exchange rate policies in LICs and the roles of credible nominal anchors.

Figure 6. Inflation in 2024-25 by Exchange Rate Regime 1/

(In percent, period average) 2/



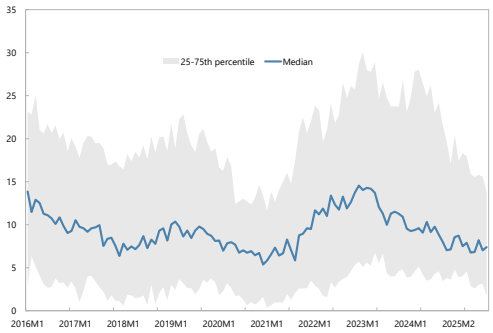
Sources: WEO, IMF staff calculations.

1/ Exchange rate regime is based on most recent AREAER.

2/ 1 = hard peg, 2 = peg under monetary union, 3 = peg, 4 = stabilized, 5 = crawling, 6 = crawl-like, 7 = other, 8 = floating

Figure 7. Private Sector Credit Growth

(In percent, year-on-year growth)



Sources: MFS, IMF staff calculations.

10. However, pockets of high inflation persist and are concentrated in FCS. In 2025, inflation exceeded 20 percent in eight LICs (mostly FCS). The highest rates (50 to 100 percent) were recorded in three countries with sharp currency depreciations. In Sudan and South Sudan, the depreciations were driven by conflict-related disruptions, weak institutions, monetary financing, low external buffers, and severe supply constraints, which amplified pass-through to domestic prices. In Zimbabwe, excess domestic liquidity linked to quasi-fiscal operations and central-bank financing fueled depreciation and inflation.

11. Medium-term inflation is anticipated to remain stable, but several risks cloud the outlook. The most immediate concern is a potential reversal of recent declines in global food and energy prices. LICs with intermediate exchange rate regimes, large macroeconomic imbalances, or weak monetary policy credibility remain particularly exposed. In these settings, renewed external price pressures could rapidly translate into domestic inflation, especially where import dependence is high and/or policy credibility is limited.

C. Reforms Are Underway, Yet More Effort Is Needed

Fiscal Consolidation Advances but Debt Vulnerabilities Remain High

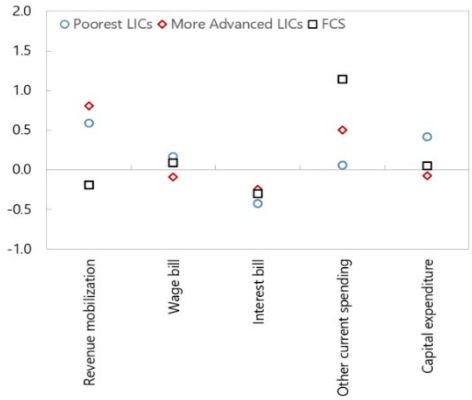
12. Fiscal consolidation is progressing but unevenly across LICs. Since 2022, LICs have been working towards reducing large post-pandemic deficits. By 2025, the median improvement in primary deficit was 1.9 percent of GDP. More advanced LICs achieved stronger improvements than the poorest LICs (respectively 2.1 and 1.5 percent of GDP) as the latter were constrained by narrower tax bases and heightened social pressures (Figure 8). Against the backdrop of weaker ODA and elevated external financing costs, these patterns are expected to continue in 2026 with a median consolidation in LICs' primary balance of 0.1 percent of GDP.

- *Domestic revenue mobilization has progressed in most LICs*, with gains more pronounced in advanced LICs. Ghana, Rwanda, Tanzania, and Togo have advanced reforms in tax policy and administration, including through digitizing systems, improving audits and case management, and enhancing transparency to bolster compliance. Some countries have also taken key steps towards rationalizing tax expenditures (TE), including by compiling their inventory and estimating the foregone revenue (a third of countries in Sub-Saharan Africa still lack these)—a complex reform that can yield significant benefits (Figure 9). The Gambia will soon complete its first comprehensive TE report (IMF, 2025f).

- *Expenditure compression has been used heavily by the poorest and fragile LICs.* In FCS, fiscal consolidation has been driven mostly by cuts in current spending. Energy subsidy reforms played a role in some countries, including in Cameroon, Chad, and Haiti, where reductions in fuel subsidies contributed significantly to adjustment. The poorest LICs (many of which are FCS) also cut capital spending, which can reflect better prioritization, but can also negatively affect growth and development going forward.

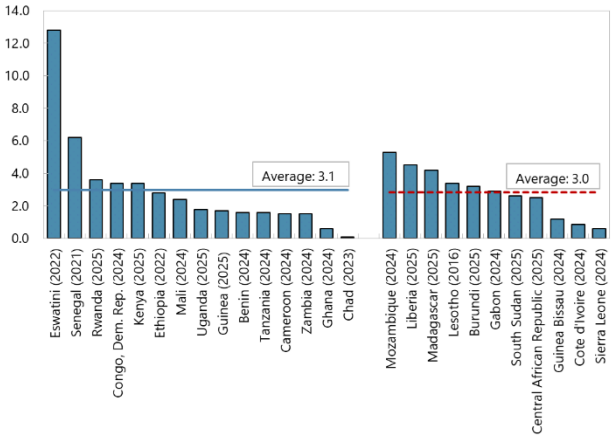
- *Interest payments have risen across all LICs*, sometimes crowding out critical development spending. In 2025, the interest bill exceeded one-quarter of fiscal revenues in nine LICs.

Figure 8. Contributions to Fiscal Consolidation, 2022-25
(In percent of GDP, median) 1/



Sources: WEO, IMF staff calculations.

Figure 9. Estimated Cost of Tax Expenditures, Year of Latest Report
(In percent of GDP) 2/



Sources: AFR Mission Chiefs TEs in SSA Survey, 2025, IMF staff calculations.

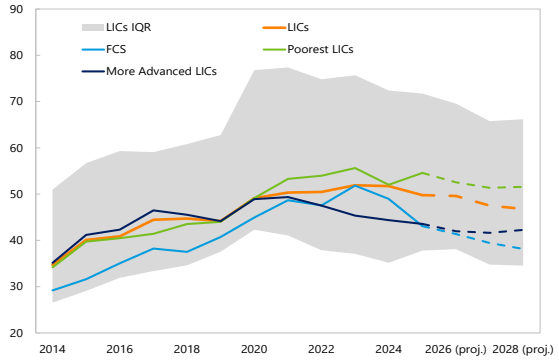
1/ A positive contribution to fiscal consolidation-indicated on the chart by positive values-indicates an improvement in the fiscal balance through higher revenues or lower expenditures (wage bill, interest bill, other current or capital expenditure).
2/ Left-hand group: based on complete estimates of tax expenditure; right-hand group: based on partial estimates implemented in the absence of high-quality data (IMF, 2025f).

13. Public debt levels are gradually declining, but debt vulnerabilities remain elevated in many LICs. At around 50 percent of GDP in 2025, the median public debt remains above pre-pandemic levels and half the LICs remain at high risk of, or already in, debt distress, even though the share has begun to decline (Figure 10). Within public debt, domestic debt is rising (Figures 10, 11) as

is reliance on regional financing for members of the CEMAC and WAEMU currency unions. The domestic debt-to-GDP ratio doubled over the past decade, with over one-fifth of LICs now holding more domestic than external debt. This pattern is even more pronounced in FCS, given their limited access to international capital markets. This trend is expected to deepen across LICs as gross financing needs remain high (projected to remain above pre-COVID levels in 2026–27), external financing becomes more expensive (relative to past years) while international capital markets remain accessible to only a few LICs, and concessional flows decline. In parallel, external debt service ratios have stabilized, though they remain above pre-pandemic levels (Figure 10). Renewed dollar appreciation could increase external debt ratios and debt service burdens in countries with predominantly dollar-denominated liabilities.

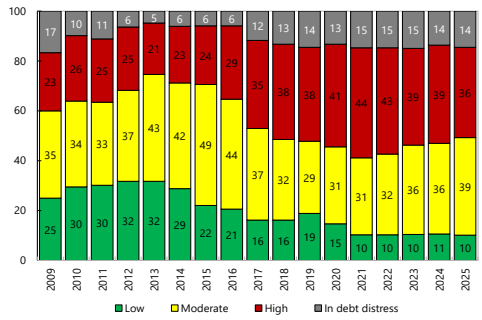
Figure 10. LIC Debt and Governance Indicators

Total Public Debt
(In percent of GDP, median)



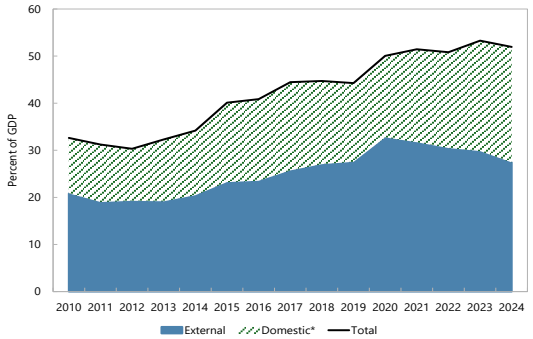
Sources: WEO, IMF staff calculations.

Evolution of IMF-World Bank LIC-DSF Risk Ratings
(In percent of total)



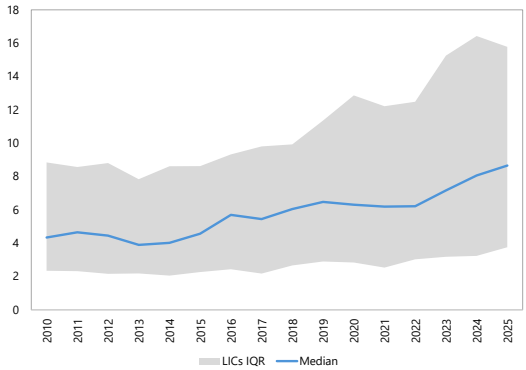
Sources: IMF-World Bank LIC-DSF database and IMF staff calculations.

Composition of Public and Publicly Guaranteed Debt
(In percent of GDP)



Sources: WEO, IMF staff calculations.
Note: *Domestic is derived as a residual, calculated as the difference between total debt and external public debt.

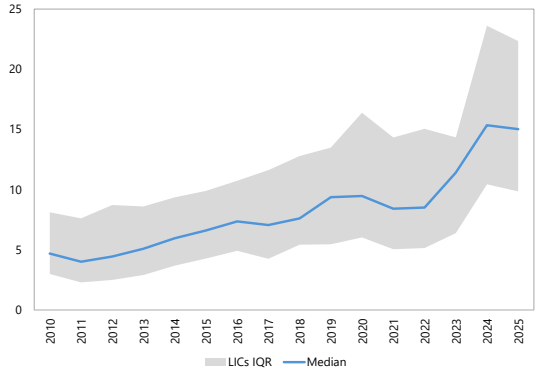
Overall Interest to Revenue
(In percent, excl. grants)



Sources: WEO, IMF staff calculations.

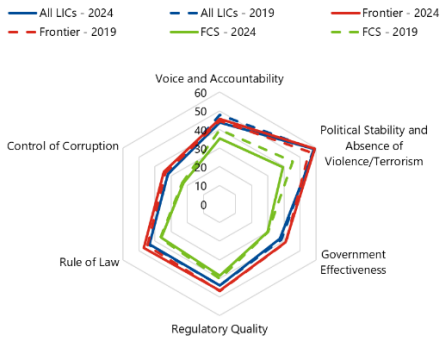
Figure 10. LIC Debt and Governance Indicators (concluded)

External Debt Service to Revenue
(In percent, excl. grants)



Sources: WEO, IMF staff calculations.

World Governance Indicators

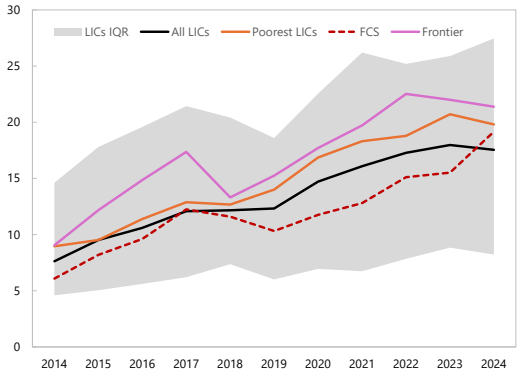


Sources: World Bank WGI, IMF staff calculations.
Note: The chart reports median indicator values, expressed as ranks, where higher ranks denote better governance.

14. While reducing FX risks, the shift towards domestic debt raises several concerns that need to be addressed:

- Domestic borrowing costs in LICs are generally higher than for external borrowing, and the effective costs may be obscured by non-marketable instruments and financial repression (IMF, 2025b). Domestic instruments that are being issued at higher rates and shorter maturities have been adding to fiscal pressures and rollover risks and keeping gross financing needs elevated. In Kenya, Malawi, Sierra Leone, Uganda, and Zambia, reliance on expensive domestic financing has resulted in significant debt service pressures. Meanwhile, new issuance across LICs has become increasingly short-term, with about 40 percent of new domestic debt placed at short maturities by 2025 (IMF, 2025a)—though about 80 percent of the existing domestic debt stock remains medium- or long-term.

Figure 11. Domestic Public Debt in LICs
(In percent of GDP, median)



Sources: IMF-World Bank LIC-DSF database and IMF staff calculations.

- Domestic debt is increasingly concentrated in the domestic banking system, reflecting underdeveloped domestic markets and a limited non-bank investor base. This raises concerns about crowding out of private sector credit and heightens the risk that sovereign stress could

transmit to the banking system (Box 2).[7] These dynamics also increase the risk of fiscal dominance and weakening of the effectiveness of monetary and exchange rate policies.

- On the upside, the shift in composition of public debt toward local-currency instruments reduces FX risks. Realization of these benefits and development of local currency bond markets will depend on the strength of policy frameworks and robustness of financial market structures to channel domestic savings into a well-functioning local market (IMF, 2025c).

15. Accelerating fiscal and governance reforms is needed to help reduce risk premiums. Recent measures include steps to improve fiscal transparency and energy governance in Chad; Ghana's adoption of a revised Fiscal Responsibility Law with stricter deficit and debt ceilings; continued SOE restructuring and liberalization in Ethiopia and Uzbekistan; advances in Madagascar's energy-sector reforms; and establishment of a dedicated anti-corruption adjudication infrastructure in Moldova. These efforts build on earlier gains reflected in improvements in political stability, regulatory quality, and control of corruption—three of six dimensions of the World Governance Indicators. Over the past five years, however, worrying signs have emerged: voice and accountability have deteriorated, and government effectiveness and the rule of law have largely stagnated. Moreover, LICs, and especially FCS, continue to rank in the lower percentiles of the global distribution (Figure 10).

Banking Sector Conditions Remain Stable Amid Rising Risks

16. Banking sector conditions in LICs appear broadly stable, but risks are growing. At end-2024, the median regulatory capital-to-risk-weighted assets ratio was 19 percent, and nonperforming loans were 4.5 percent of total loans. However, these aggregates mask mounting vulnerabilities. Growing reliance by governments on shorter-term and expensive domestic financing, often from domestic banks, is exacerbating already high sovereign-bank linkages (Box 2).[8]

17. In response, some LICs are advancing financial sector reforms that enhance regulatory frameworks, deepen financial markets, and expand access. Ghana, for instance, progressed with bank recapitalization following its Domestic Debt Exchange Program under the Ghana Financial Stability Fund, with near-full compliance by 2026. Rwanda sustained its financial market reforms to improve interbank operations and monetary transmission under its interest-rate-based framework. Somalia strengthened regulatory oversight and AML/CFT compliance through key legislative reforms, including amendments to its AML/CFT law and adoption of the Financial Institutions Law in May 2025. Efforts to boost financial inclusion are progressing too. Uganda launched its second National Financial Inclusion Strategy (2023–28), emphasizing digital and green finance. Kenya introduced a new strategy for 2025–28 focused on digital innovation and consumer protection. Cameroon implemented its 2023–27 strategy to broaden access to affordable financial services.

[7] Central banks in LICs held 9 percent of total domestic debt in 2024, about half of what they held a decade ago.

[8] Data gaps complicate risk assessment. Many LICs report Financial Soundness Indicators to the IMF with a lag and less than seven LICs report key liquidity metrics (e.g., the liquidity coverage ratio and net stable funding ratio).

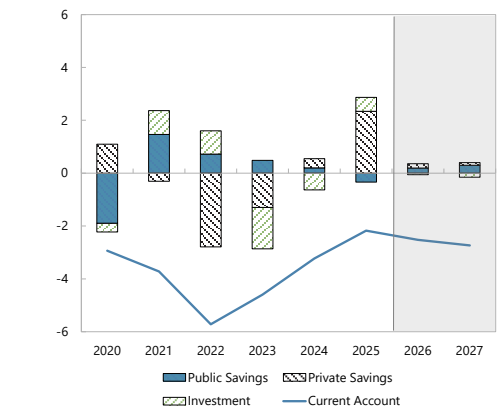
Current Account Deficits Hold Steady and Many LICs Have Thin Reserves

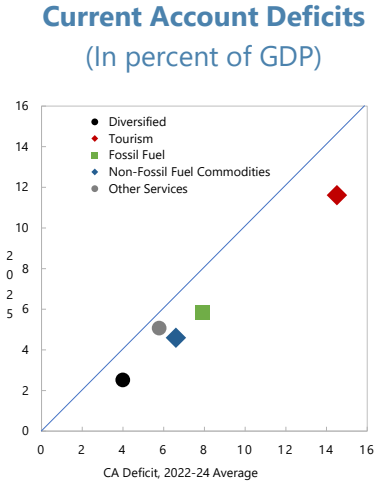
18. Broad stability is anticipated in LIC current account (CA) deficits, following a recent narrowing (Figure 12). After shrinking to 3.4 percent of GDP in 2025, the median deficit is expected to stay within 4 percent of GDP in the coming years—assuming gradual export diversification, productivity improvements, and stable commodity prices.[9] Key considerations include:

- *Savings and investment.* In an uncertain global environment where yields are high, private savings in LICs are making a positive contribution to the CA balance (Figure 12). That said, private saving rates—about 14–16 percent in 2024–25—remain well below the 21–22 percent observed in EMs and AEs, underscoring the need for policies that raise private savings through greater financial inclusion, macroeconomic stability, deeper financial markets, and stronger institutions. In some LICs, reduced public investment (part of fiscal consolidation efforts) is also playing a role in narrowing CA imbalances.

- *Commodity prices.* Two-thirds of LICs (out of 56 with available data) are benefiting from improved terms of trade—for most, both export and import price dynamics—that are expected to prevail for some time (Figure 12). This reflects softer energy and food prices and stronger prices for precious metals and AI-related inputs. In contrast, led by oil price developments, terms of trade worsened for LIC fossil-fuel exporters.

Figure 12. Current Account Developments in LICs

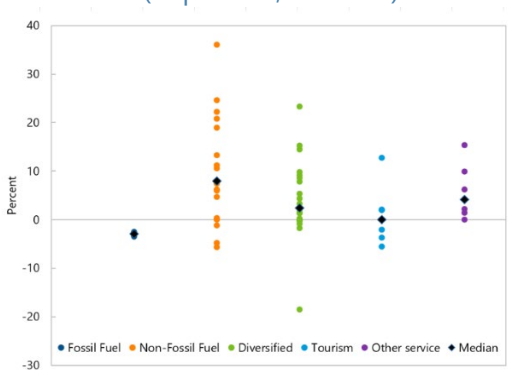




[9] EBA-Lite assessments confirm a significant narrowing of CA gaps over the past two years, as the difference between actual balances and structurally negative norms has fallen significantly.

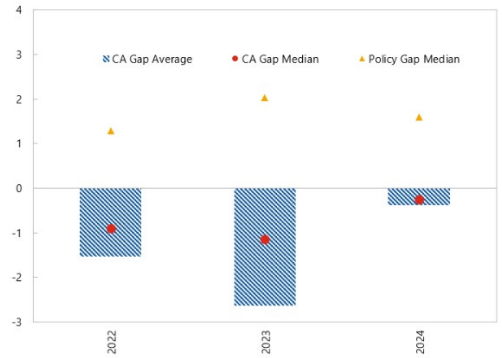
Figure 12. Current Account Developments in LICs (concluded)

Terms of Trade Change
(In percent, 2024-25)



Sources: WEO, IMF staff calculations.

Current Account and Policy Gaps
(In percent of GDP)



Sources: IMF ESA database.

1/ Variables are calculated based on aggregation over all countries in the relevant income group for each year for which data is available. Averages are unweighted.

- *Benign impact of changes in US tariffs.* The direct effect on most LICs has been modest thus far—except those with substantial US trade (Box 1), where frontloading of product shipments to the US in early 2025 lifted export volumes. The indirect impact is also expected to remain muted unless trade policy changes in the world's largest economies significantly weaken global economic activity.

- *Remittances.* Amid concerns over tighter immigration policies, some countries (Haiti, Honduras, Nicaragua) are experiencing strong inflows (Box 3). As these policies take effect, remittances are projected to decline, though uncertainties remain high over this critical source of foreign exchange flows for many LICs.

19. While on the rise, foreign exchange reserves remain thin for many LICs. Foreign exchange reserves have significantly improved for most LICs, with the median, and especially the 75th percentile, now around or above pre-pandemic levels in terms of months of import coverage (Figure 2). Median LIC reserve coverage was 3.8 months of imports in 2025 and is projected to rise gradually to 4.2 months of imports by 2029. The top quartile is progressing even faster, from 6.1 months of imports in 2025 to a projected 6.9 months by 2029. However, the situation is less favorable for the bottom of the distribution: 26 LICs remained below the recommended 3-month threshold at end-2025, and 17 (nearly one-quarter of all LICs—mostly FCS) are projected to remain below 3 months by 2029, leaving them vulnerable to commodity price swings, shifts in global interest rates, and interruptions in concessional support.

A SHIFTING EXTERNAL FINANCING LANDSCAPE FOR LICS

A. Major Evolutions in External Inflows

20. LICs are experiencing major shifts in levels and composition of external financing.

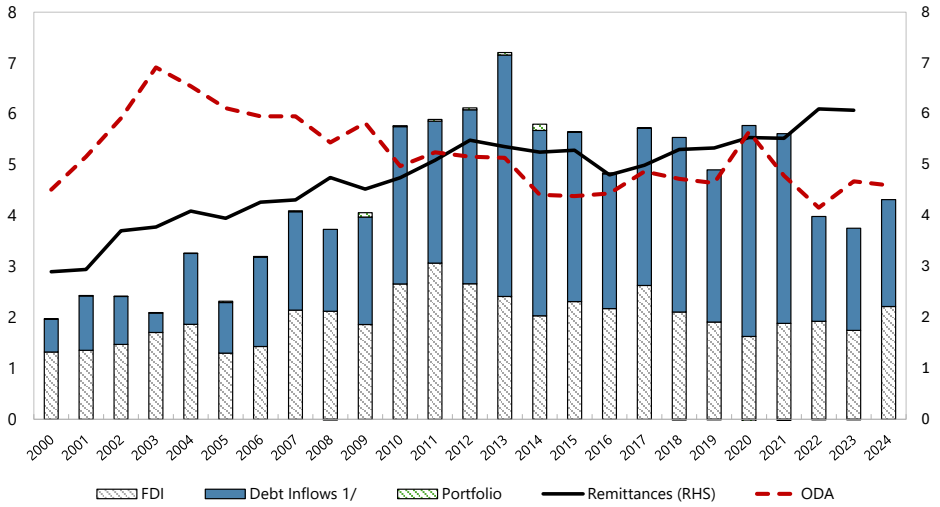
- After peaking during 2010-14, net financial inflows to LICs fell by one-third, to around 4¼ percent of GDP by 2024 (Figure 13), driven by declines in both FDI equity flows and, more recently, external debt.[10] These trends are consistent with broader post-GFC developments: lower risk tolerance and increased "home" bias (Milesi-Ferretti and Tille, 2011), stalling of financial integration (Lane and Milesi-Ferretti, 2018), and, more recently, a decline in trade and investment flows between geopolitically distant countries (Gopinath et al., 2025a, b).

- The share of external debt flows (relative to total flows) has fallen from 60 percent in 2010-14 to half in 2024, primarily reflecting the retrenchment of external debt taken on by the domestic private sector in LICs—especially since 2022 when AE central banks hiked interest rates to combat soaring post-pandemic inflation, thus contributing to the tightening of international financial conditions, and domestic risks constraining access of many LICs to international markets. ODA flows to LICs since 2022 have also declined substantially as donor countries reassessed their spending and policy priorities. In contrast to previous flows,[11] remittances have been steadily growing so far. However, this may change given ongoing shifts in immigration policies worldwide.

- While the evolution in LICs' external financing partly reflects trends that started several years ago, including before the COVID-19 pandemic, recent policy shifts in major economies are exacerbating the challenges. Preliminary data suggest that external financing to LICs remained subdued in 2025, with sharp declines in ODA, some stability in FDI, and a small rise in portfolio investment as several LICs (Benin, Côte d'Ivoire, Kenya, Republic of Congo) returned to international markets, though on expensive terms. These developments call for appropriate policy actions.

[10] FDI inter-company debt flows in LICs are small.
[11] Portfolio investment remains minimal for most LICs, reflecting shallow financial markets and limited investor reach.

Figure 13. Net External Inflows to LICs /2
(In percent of GDP)

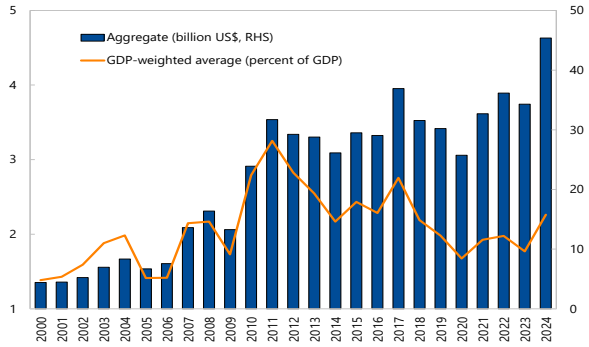


Source: World Bank IDS, OECD DAC2A database, WEO and IMF staff calculations.
Notes:
1/ Consists of long-term public and publicly guaranteed debt (including IMF), long-term private debt not guaranteed by the public sector, and short-term debt.
2/ ODA flows in this chart and in other sections in this report are comprised mostly of grants, but also include concessional loans from bilateral and multilateral creditors to LICs, as classified under the ODA standard in the DAC statistical system. Consequently, these flows partially overlap with the debt inflows.

Foreign Direct Investment: Subdued and Increasingly Uneven

21. FDI, the most growth-enhancing form of external financing, has suffered declines through most of the 2010s, with limited recovery in recent years. Although US dollar levels of FDI may appear large, net FDI inflows declined from an average of 2.5 percent of GDP in the pre-pandemic decade (2010-19) to 1.7 percent of GDP in 2020, with a limited gradual increase to 2.3 percent of GDP by 2024 (Figure 14). This raises concerns since FDI can bring capital, technology, and managerial know-how to LICs. Being more stable and mostly in the form of equity, FDI is generally associated with stronger growth and lower volatility than (non-FDI) external debt (Prasad et al., 2007). Implementing appropriate policies to counter the decline in FDI will be essential for future growth and development prospects in many LICs. Earlier analysis (IMF, 2025d) highlights fiscal policy and institutional quality as key drivers, and Section II examines their role in attracting FDI.[12]

Figure 14. Net FDI Inflows to LICs
(In US$ billion and percent of GDP)



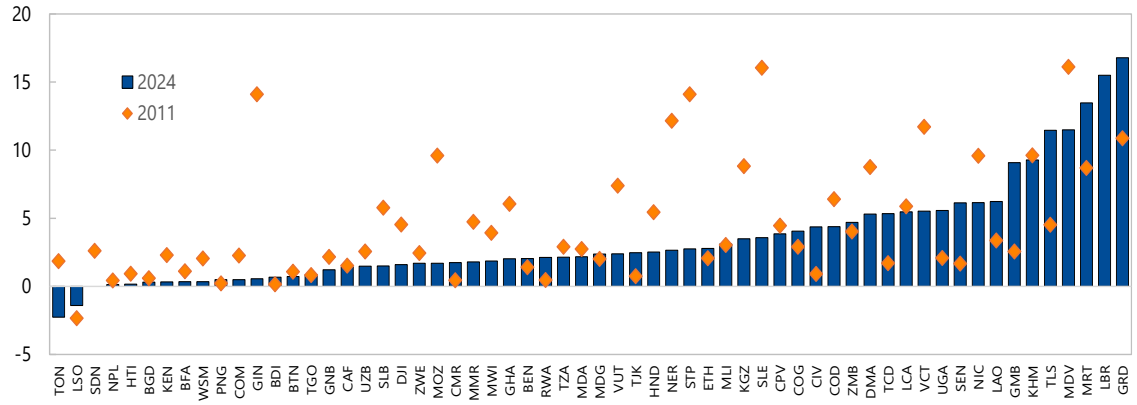
Sources: WEO, IDS, IMF staff calculations.

[12] Global factors influencing FDI flows to LICs—such as global risk sentiment, interest rates, and non-fossil fuel commodity prices—are discussed in Annex II.

22. The distribution of FDI flows across countries has also shifted. Between 2011 and 2024, the number of LICs with net FDI inflows above 7 percent of GDP was more than halved from 16 to 7 (Figure 15). This suggests that fewer countries are perceived as a destination for large-scale investment. FDI in LICs has also gradually moved away from commodity exporters to exporters of more diverse goods and services (Figure 16). The latter now receive more than two-thirds of LIC FDI flows whereas the commodity exporters receive less than a third—down from nearly a half in early 2010s. FDI inflows to FCS are lackluster against a backdrop of fragility and conflict, and weaker investment in the commodities sector. Recent evidence suggests that the global shift of FDI toward services has benefited larger and more competitive EMDEs, where higher skill levels make it easier to benefit from productivity and technology spillovers (World Bank, 2024; World Bank, 2025; UNCTAD, 2025). At the same time, UNCTAD (2025) documents declining investment in infrastructure and development-related sectors in LICs, underscoring the need for targeted policies to attract high-quality, development-enhancing FDI to LICs.

Figure 15. Distribution of Net FDI Inflows to LICs

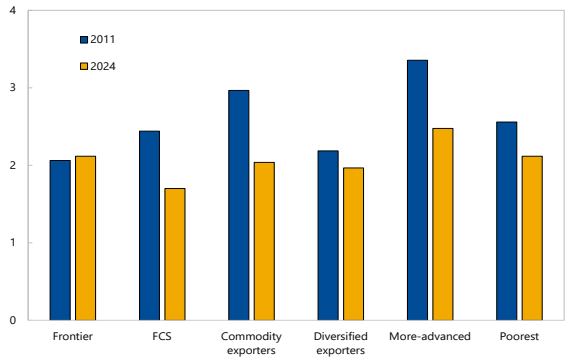
(In percent of GDP)



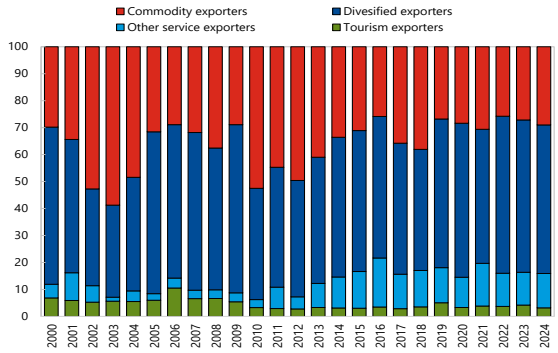
Sources: WEO, IDS, IMF staff calculations.

Figure 16. LICs: FDI Net Inflows and Structure

(In percent of GDP)



(In percent of total)



Sources: WEO, IDS, and IMF staff calculations

Net External Debt Inflows: Tighter and More Expensive

23. LICs have experienced a sharp decline in net external debt inflows in recent years, with FCS facing pronounced reductions (Figure 17). The largest declines have been recorded among commodity exporters (both fossil fuel and other commodity exporters). At 2.1 percent of GDP in 2024, total net external debt inflows to LICs were about half their 2020-21 levels, and significantly below the 2010-19 average of 3.3 percent of GDP.

- The drop in external inflows to LICs reflects a sharp decline in external borrowing from foreign banks and other external private creditors by the domestic private sector in LICs—from over 2 percent of GDP in 2013 and 1.1 percent of GDP over 2010-19 to nearly zero in 2024.[13] While this reduces risks from currency mismatches and sudden stops that characterize these types of flows (Miranda-Agrippino and Rey, 2020), the alternative source of financing for the LIC private sector is expensive domestic financing.

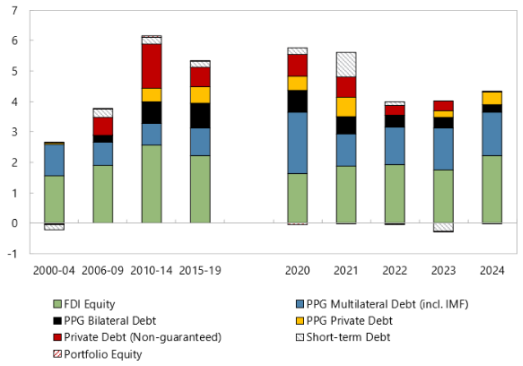
- The largest source of net external debt inflows to LICs—i.e., total public borrowing from multilateral and bilateral sources—has been broadly stable. However, its composition has changed, with increased multilateral financing and reduced bilateral financing—except in FCS, where multilaterals did not fully replace the drop in bilateral financing. Overall, multilateral and Paris Club lenders significantly increased non-concessional lending, while disbursements from non-Paris Club bilateral lenders, in particular China, declined for both concessional and non-concessional loans.

- Public sector borrowing from private external creditors (bonds, commercial banks, and other sources) and net inflows of short-term external debt (financing both public and private sectors) are all much smaller but have also experienced declines.

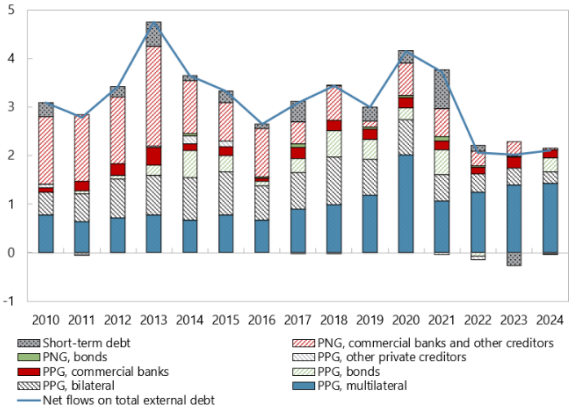
[13] Here and below, public and publicly guaranteed (PPG) debt is referred to as public sector borrowing and private non-guaranteed (PNG) debt as private sector borrowing. PPG debt includes external borrowing contracted by the public sector as well as private sector borrowing that carries an explicit public guarantee. PNG debt refers to external borrowing by private entities that does not benefit from a public guarantee. Definitions follow World Bank International Debt Statistics (IDS).

Figure 17. LICs: External Debt Flows 1/2/

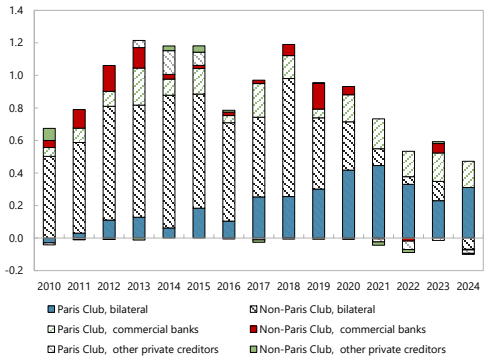
Net Inflows to LICs
(In percent of GDP)



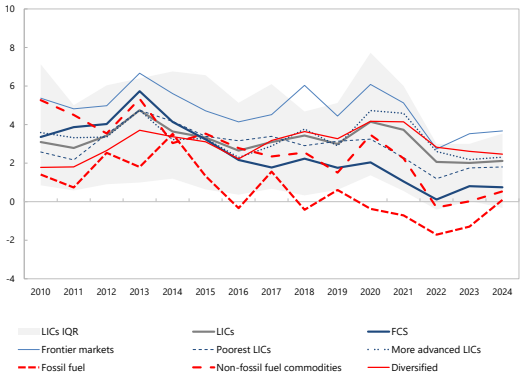
Composition of Net External Debt Inflow
(In percent of GDP)



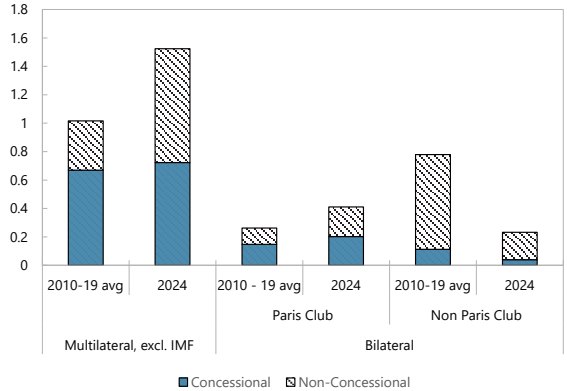
Composition of Bilateral and Private Net Inflows to the Public Sector, by Creditor
(In percent of GDP)



Net External Debt Inflows to LICs
(In percent of GDP)



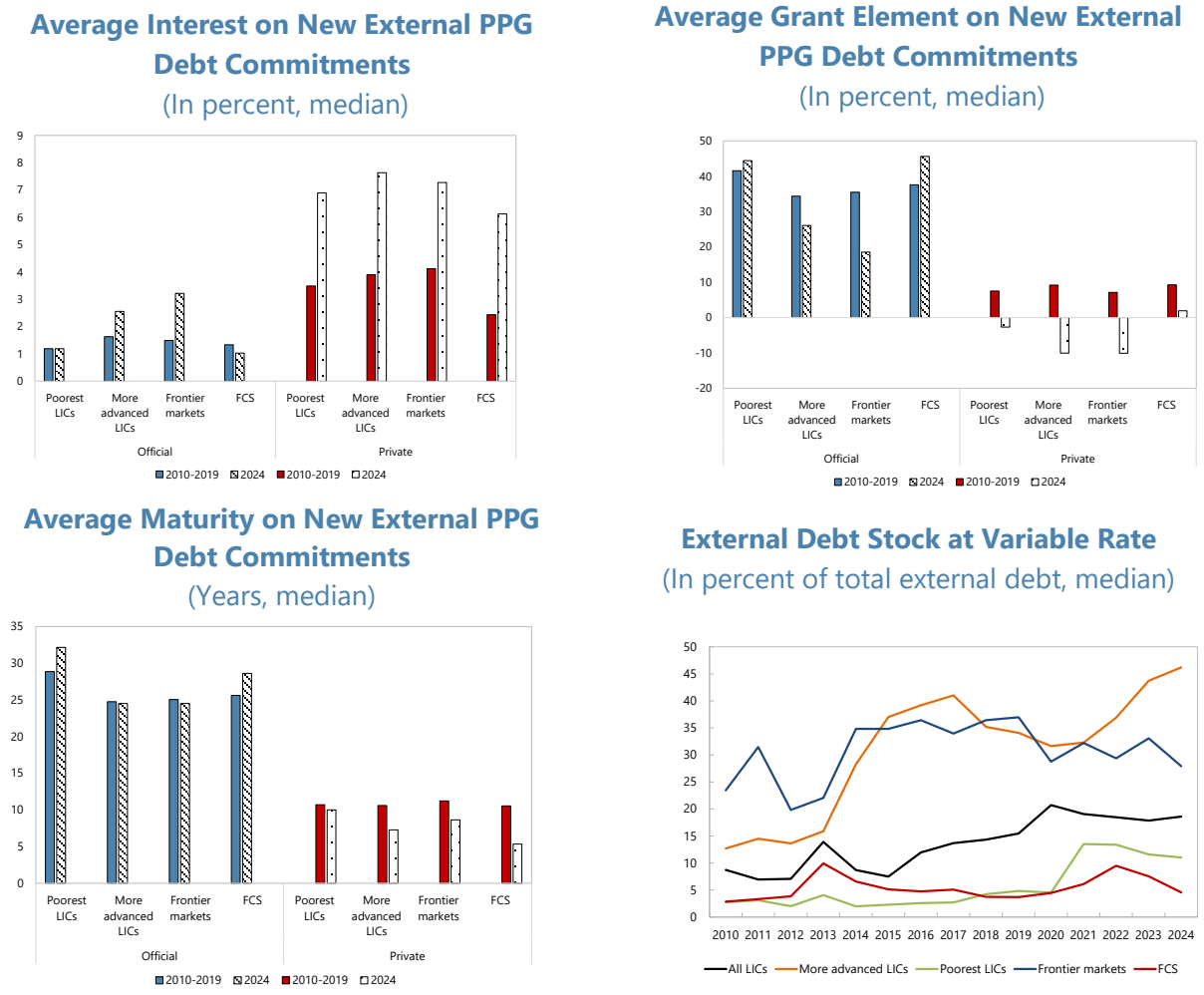
Concessionality of External Official Debt Disbursements to LICs
(In percent of GDP)



Source: World Bank IDS, WEO and IMF staff calculations.
1/ PPG denotes public and publicly guaranteed debt; and PNG denotes private debt not guaranteed by the public sector.
2/ Net inflows are defined as disbursements net of amortization.

24. Market-based public sector borrowing has become more expensive, while multilateral and bilateral creditors have protected concessionality for the most vulnerable LICs (Figure 18). New lending commitments from external private creditors have been contracted at higher interest rates, shorter maturities, and lower grant elements (based on the IDS measure of concessionality[14])—increasing rollover and interest-rate risks. The share of new external debt issued at variable rates has also risen in recent years, especially for more advanced LICs, heightening sensitivity to global financial conditions for those relying more heavily on market-based financing. By contrast, official creditors have adjusted terms more gradually. The grant element on new debt commitments from multilateral and bilateral sources has been preserved—or even increased—for the poorest LICs and FCS, which also enjoyed unchanged or lower interest rates and longer maturities.

Figure 18. LICs: Terms of External Debt Flows 1/



Sources: IDS, IMF staff calculations.
1/ Official denotes all multilateral and bilateral lenders.

[14] Concessional debt is defined here as loans with an original grant element of 35 percent or more, using a 5 percent discount rate.

ODA: Reduced and Shifting Towards Loans and Project Financing

25. ODA has been and remain a key financing source for LICs but are currently under important strains (Figure 19). In this report, ODA flows comprise grants and concessional loans from both bilateral donors and multilateral institutions.[15,16] For LICs, the bulk of ODA consists of grants, delivered largely through the public sector and concentrated in social, humanitarian, and infrastructure spending (Box 4). Not only does ODA support development, but it also plays an important stabilizing role during downturns in the domestic business cycle (Lastauskas and Shang, forthcoming). ODA, however, is under significant strain, marked by substantial cuts and shifts in composition.

26. ODA to LICs is undergoing a major transformation, marked by a decline as a share of LIC GDP, a shift from grants to loans, and an increasing share of project-support. In recent years, ODA to LICs declined significantly as a share of LIC GDP (despite a slight recovery in 2024), partly due to ODA resources being redirected toward EMs or inward expenditures in donor countries on issues such as refugees (Figure 19).[17] By 2023-24, net ODA flows to LICs fell to 4.3 percent of GDP—relative to an average of 5 percent during 2010-14.[18] In parallel, the share of net loans (vis-a-vis grants) in total net ODA flows has significantly risen from 3 percent in 2010 to 28 percent by 2024. Similarly, the share of project support (financed by grants or loans) in total net ODA has risen in recent years and is expected to further rise based on recent announcements by key ODA providers. Looking ahead, OECD data shared with IMF staff indicate further reductions: from 2025 onwards, where ODA-type flows from traditional bilateral donors to LICs could decline by 0.7 percent of LIC GDP (US$11 billion in constant 2023 prices).

[15] Members of the OECD's Development Assistance Committee (DAC), which computes ODA statistics, include Australia, Austria, Belgium, Canada, Czechia, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, South Korea, Slovakia, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, the United States, and the European Union. For purposes of this report, "ODA" includes grants and concessional loans from members of the DAC as well as from non-DAC countries that voluntarily report to the OECD (Azerbaijan, Bulgaria, Croatia, Cyprus, Israel, Kazakhstan, Kuwait, Liechtenstein, Malta, Monaco, Qatar, Romania, Taiwan Province of China, Thailand, Timor-Leste, Turkey, and the United Arab Emirates). It also includes flows from multilateral institutions to LICs to the extent they are included in the DAC statistical system.

[16] Concessional debt for ODA purposes is defined by the OECD DAC as follows: for a country classified as a "low-income country" or a "least developed country" in the World Bank or UN classification, ODA loans must have a grant element of at least 45 percent, using a 9 percent discount rate; for a country classified as "lower-middle-income country" in the World Bank classification, ODA loans must have a grant element of at least 15 percent, using a 7 percent discount rate.

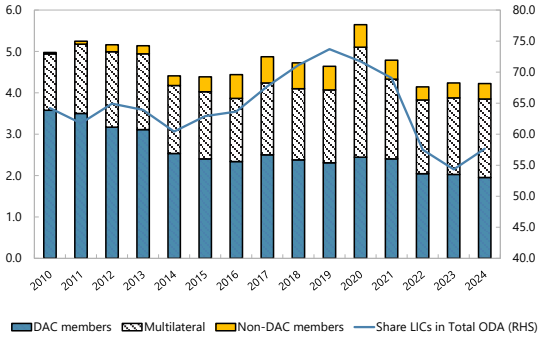
[17] US$88 billion out of a total US$255 billion ODA in 2024 (in current prices) are reported as unspecified (developing countries unspecified plus amounts reported for specific regions as country-unspecified), not allowing country-specific matching.

[18] The discussion in this section builds on the OECD DAC2A dataset. Differences across OECD, IDS, and BOP data sources may reflect variations in definitions, coverage, timing, and accounting treatments, and figures should therefore be interpreted as indicative of broad trends rather than precise numbers.

Figure 19. ODA Flows to LICs

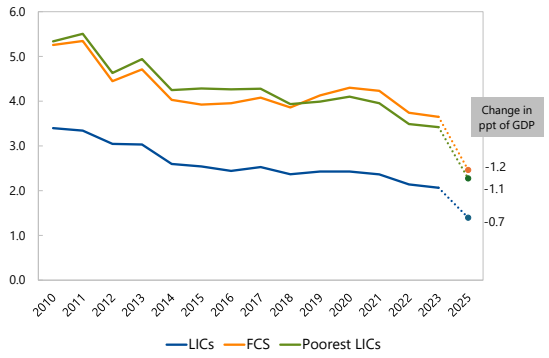
Net ODA Flows to LICs and Share in Total Net ODA 1/

(In percent of LIC GDP)



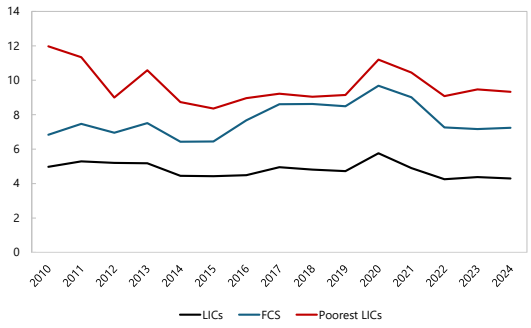
Bilateral DAC ODA Disbursements to LICs

(In percent of GDP in each group)



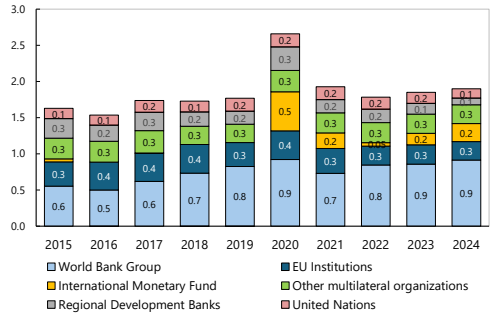
Net ODA Flows to LIC Groups

(In percent of GDP in each group)



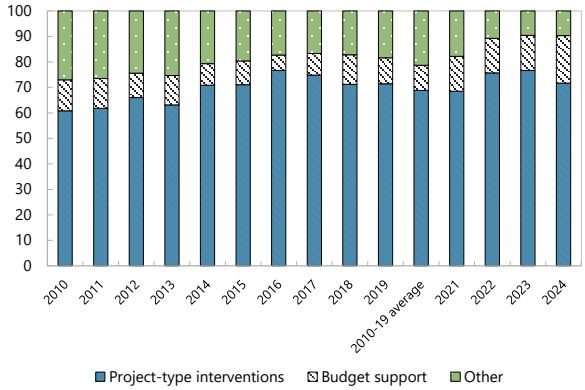
Net Financial Aid Flows to LICs from Multilaterals

(In percent of LIC GDP)



Net ODA Flows to LICs by Modality of Execution

(In percent of total)



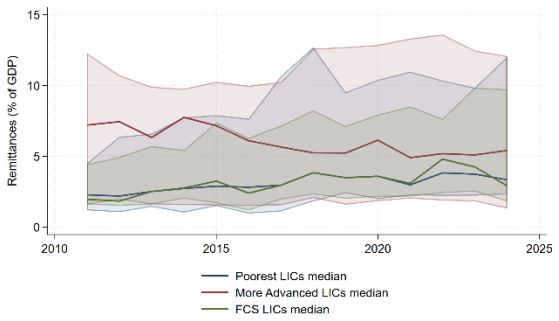
Sources: OECD DAC2A and CRS databases and IMF staff calculations.

1/ ODA comprises grants and concessional loans from members of the DAC, from non-DAC countries, and multilateral institutions. Net loans are defined as gross loans less concessional loan repayments and offsetting entries for debt relief. Grants include grant recoveries. Observations up to 2024 are outturns. Projections for 2025 are staff computations derived from preliminary OECD survey results.

Remittances: Still a Vital Source

27. Remittances remain a vital source of external financing for LICs. Inflows are highly heterogeneous across countries, ranging from a few percent of GDP in some LICs to more than 30 percent of GDP in Nicaragua and 40-50 percent of GDP in Tajikistan. Historically, more advanced LICs have received larger remittance inflows in level terms, while growth in remittances has been faster in the poorest LICs (Figure 20). Broadly uncorrelated with other capital flows (Lastauskas and Shang, forthcoming), remittances have been important for smoothing consumption—playing a countercyclical role, cushioning periods of reduced incomes and wages in recipient countries—supporting spending on education and health care, and more generally reducing poverty. On the other hand, they are less frequently used for productive investment (IMF, 2025d) and can raise reservation wages, resulting in reduced labor supply and eroded competitiveness (Chami et al., 2018).[19] Increased transmission of remittances through digital channels is adding to crypto-asset risks, though it is also reducing fees, which partially mitigates the impact of tighter immigration policies (Box 3).

Figure 20. LICs: Inflows of Remittances
(In percent of GDP, median; P25-P75 bands, 2011-2024)



Sources: World Bank WDI; IMF staff calculations.

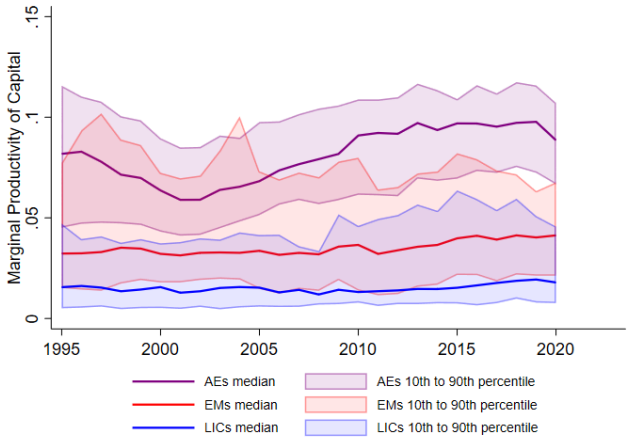
B. Declining External Flows and Lower Capital Returns in LICs

28. Generally modest and, for some years now, declining external flows to LICs could be partially explained by a rising gap in the marginal product of capital in LICs relative to advanced economies. LICs' low capital ratios imply higher marginal products of capital (i.e., the output produced from an additional unit of capital), which, absent frictions, should attract foreign capital until, over the long run, marginal productivities are equalized across countries. However, the marginal productivity of capital in LICs is adversely affected by a lack of complementary factors such as skilled labor, infrastructure, technology, and policy and institutional constraints. New cross-country evidence suggests that the marginal product of capital in LICs has not only been generally lower than in other economies, but the gap with advanced economies has widened since the early 2000s—particularly following the dot-com boom and the commodity super-cycle (Figure 21, Annex III). The gap exists for both public and private capital, but it is more pronounced for public capital, pointing to inefficiencies in LIC public investment management (Lowe et al., 2018, Box 5).

[19] When remittances put upward pressure on prices and the real exchange rate, they can erode external competitiveness and shift activity toward lower value-added non-tradables (Chami et al., 2018).

29. These findings suggest that domestic institutional and policy weaknesses, rather than frictions in international capital markets, represent key constraints on investment. These weaknesses—such as insufficient basic infrastructure (e.g., electricity and roads), poor access to education, and weak property rights—hold back significant improvements in the productivity of capital and keep the relative costs of investment goods and risk premia high. All these factors weigh on both domestic and foreign investors.

Figure 21. Marginal Productivity of Capital (MPK)
(1995-2020)



Sources: Penn World Table 11.0; The Changing Wealth of Nations; IMF staff calculations.

POLICY PRIORITIES

A. Resolute Domestic Policies and Reforms

30. Resolute domestic policies and reforms will be key to navigating global uncertainties and the shift in external financing. Continued fiscal consolidation will be necessary in most LICs, including through well-designed and sequenced domestic revenue mobilization and prioritization of spending, along with strengthening public financial management and debt management, where calibration and pace will depend on each country's circumstances. In this context, greater scrutiny of public sector borrowing, especially on non-concessional terms, will be essential for preserving debt sustainability and maintaining adequate buffers. Monetary and exchange rate policies must continue to focus on price stability while safeguarding financial stability. Improvements in the quality and coverage of data will be central to supporting the success of macroeconomic policies. In addition, structural reforms conducive to private sector-led growth and job creation must be accelerated. While challenging, targeted governance reforms aimed at combating corruption and improving the effectiveness of government institutions and central banks will also be fundamental to foster social support for macroeconomic adjustments and structural reforms, as well as to counter external financing declines and reduce borrowing costs. Steadfast and parallel pursuit of these policies and reforms is essential to underpin macroeconomic stability and build up buffers. They would also raise investment returns in LICs and reduce informational asymmetries—attracting FDI, enhancing the impact of concessional financing, and lowering external borrowing costs, thus supporting external adjustment and reducing vulnerabilities.

31. As fiscal consolidation progresses, LICs should safeguard priority development spending and boost domestic revenues. Spending should prioritize high-quality investment, including to improve resilience to climate and natural disaster risks, and well-targeted social spending which supports durable adjustment. Fiscal structural reforms should focus on mobilizing domestic revenue and enhancing transparency and governance, including in the extractive sector. In more detail:

- *Boosting domestic revenue as concessional financing (grants and loans) declines*. More than half of LICs mobilize less than 15 percent of GDP in tax revenue—below the level typically associated with stronger and more sustained growth.[20] Experience suggests simultaneous advances in both tax policy and tax administration are needed, along with rationalization of tax expenditures and tax incentives. Countries that have achieved meaningful gains—such as Ghana, Rwanda, Tanzania, and Togo—have done so by digitizing tax systems, piloting targeted reforms, improving cash management, investing in capacity, and fostering trust through greater transparency and avoiding distortive taxes.[21]

- *Improving the efficiency of public spending*. Substantially lower returns to capital in LICs relative to advanced economies, especially for public capital, suggest sizeable inefficiencies in public financial management. On average, about 40 percent of resources allocated to LICs for creating and maintaining public infrastructure are lost due to inefficiencies (Schwartz and others, 2020), particularly in health and education (IMF, 2021a; Soto, 2025). Reducing these inefficiencies and raising returns to public spending in LICs (including on capital)—which could also boost the returns to private capital—will require strengthening governance and institutions with a focus on public investment planning, implementation, and risk management frameworks (Box 5). Essential and complementary reforms include enhancing cash management, budget planning with medium-term fiscal and macroeconomic frameworks, and transparency and accountability by publishing key budget documents, and curtailing untargeted subsidies.

- *Safeguarding and strengthening social safety nets.* This will be especially critical for countries where a substantial proportion of households depend on remittances. Targeted social assistance and facilitating access to education and healthcare will help limit the adverse impact of any remittance declines on households' consumption and human capital investment.

- *Managing the shift in ODA to project financing (in place of budget support).* In addition to improving the returns on public capital investment, developing and maintaining a rolling project pipeline strategically linked to national development and sector plans will be critical to giving donors confidence to invest in on-budget projects. Having donor-financed projects "on budget" and integrated into core PFM frameworks is important as they are then subject to parliamentary approval and audit, captured in fiscal risk analysis, benefit from integrated cash and commitment control, and remain anchored in a coherent, country-owned public investment strategy. In cases where donors opt to work outside the budget, it would still be important for the government to facilitate coordination across donors to avoid duplication and encourage synergies and sequencing across projects.

32. Improvements in debt management should prioritize planning, transparency, and capacity building. With still high market borrowing costs and declining external flows, LICs need to proactively manage refinancing risks while preserving debt sustainability. Priorities include:

[20] See Baer et al. (2025), which also includes detailed recommendations on designing reforms to raise tax revenue.
[21] See IMF (2025e), which elaborates on the referenced country cases.

- Anchoring borrowing plans in credible and proactive medium-term debt strategies, supported by debt sustainability analyses.

- Enhanced debt transparency and data reporting practices. Combined with building capacity in debt management offices and strengthening legal frameworks, this will also be essential to more effective debt management. This is particularly important for frontier LICs, some of which have increasingly relied on alternative funding strategies—such as private placements, collateralized borrowing, and securitization of future revenues—to address near-term financing needs. While these instruments can provide temporary relief, they often involve higher rollover risks and can obscure the true size and structure of public debt and future repayment obligations.

- Proactive debt management in relation to external commercial debt. This can include timely prefinancing and rollover of large maturities to help reduce external debt service burdens. Where appropriate, the use of risk-sharing instruments, credit enhancements, and innovative financial tools can help de-risk investments and crowd in private capital at more affordable pricing. With respect to the existing stock of debt, debt exchanges and debt buybacks can also be considered to reduce debt service costs and increase development spending. The World Bank guarantee platform can support some of these efforts.

- When ready, obtaining sovereign credit ratings and achieving improvements in these ratings. The latter could lower borrowing costs and raise portfolio flows and FDI to LICs—by providing key signals on sovereign risk, including on macroeconomic fundamentals and policies. This signaling can be particularly effective during periods of high uncertainty (Annex IV).

- Developing domestic financial markets. This should progress steadily, with a view to mobilizing domestic private savings and expanding domestic financing sources.

33. Improvements in monetary frameworks and implementation of exchange rate policies will be critical to achieving price stability and resilience to shocks. Monetary and exchange rate policies must remain alert to renewed inflation risks, especially given high exposure to global food and energy prices. Where inflation remains elevated or expectations are not yet firmly anchored, policy settings may need to stay tight. Ensuring consistency in the macroeconomic policy mix will be essential to reinforce disinflation efforts. Further improvements in monetary frameworks—including enhanced liquidity management and clearer operational targets—and greater exchange-rate flexibility, where appropriate, will strengthen policy credibility and help absorb external shocks.

34. Greater vigilance in safeguarding financial stability is called for given risks from a growing reliance on domestic financing and digitization. In the context of reduced external financing and slow materialization of domestic revenue mobilization and expansion of domestic financial markets, governments' reliance on domestic borrowing from commercial banks (directly or indirectly through bond issuance) elevates risks of sovereign stress transmission to the banking system and the rest of the economy (Box 2). Safeguarding the banking system requires strengthening prudential oversight, improving stress-testing frameworks, introducing risk-based capital requirements for sovereign holdings, and monitoring sovereign–bank linkages, including by

ensuring adequate capital buffers. For currency unions, this also involves better coordination with the regional financial supervisor. In parallel, while digitization is improving financial inclusion, it is also raising volatility of cross-border flows and contributing to "cryptoization", which undermines monetary sovereignty. Capturing the benefits while containing financial stability risks will rely on robust regulation and supervision, strong AML/CFT frameworks, and better data.

35. Accelerated structural reforms should aim to enhance domestic resilience and private sector-led growth and jobs. Durably higher growth rates in LICs are needed to ensure sufficient job creation and absorb the rapid increase in their working-age population, as well as to secure a lasting and significant improvement in living standards and per capita GNIs. Structural reforms in governance, state-owned enterprise management, export diversification, and resilience-building will help LICs better manage external shocks, attract private investment, and strengthen productivity—ultimately raising medium-term growth prospects. Improving the business environment and easing barriers to entrepreneurship, alongside investment in education, health, and vocational training, are critical to boosting human capital and absorptive capacity—including for maximizing FDI-related technology and knowledge spillovers (Farole and Winkler, 2012; Adarov and Pallan, 2025). Policies should also focus on enhancing price competition in domestic markets and raising efficiency of production in the investment goods sector (IMF, 2019). Ensuring that growth dividends are widely shared and vulnerable groups are protected is essential for sustaining reforms, particularly in the post-pandemic context of setbacks in poverty reduction, female labor force participation, and informality (IMF, 2024b).

B. External Support

36. Concessional financing should be focused on where it is most impactful. Against the backdrop of declines in bilateral grants that cannot be fully compensated by multilateral support, bilateral and multilateral partners should be more selective in channeling concessional financing flows. This suggests that:

- More advanced LICs would experience larger reductions in grants and concessional loans since they have access to international market financing. They also have the capacity to implement reforms faster than other LICs, enabling them to raise domestic revenues, improve the targeting and efficiency of spending, lift relative returns to capital, and reduce informational asymmetries sooner. In turn, they can attract FDI and reduce both their domestic and international borrowing costs faster. Where appropriate, the international community can support the mobilization of private finance by expanding risk-sharing instruments and blended finance mechanisms that crowd-in private capital.

- The poorest LICs and FCS would benefit from the focus of bilateral and multilateral support. This would reflect the lack of access to affordable international market borrowing, shallow domestic financial markets, and limited capacity in these countries. The shift from grants to loan-based financing could also be more gradual, given lower public investment and debt management capacity—especially for countries facing debt service challenges.

- More project-based concessional financing flows (in place of budget support) would require enhanced efforts to improve project management. This would involve elevating the prioritization of high-return investment and reducing rent-seeking behavior and inefficient current spending. Where market financing needs to be raised, focusing on public financial and debt management reforms would help reduce borrowing costs.

37. Making the most of concessional financing will require enhanced coordination across all parties involved. This means not only better coordination with LIC authorities but also stepping up collaboration and coordination across multilateral and bilateral partners. In this context, the emphasis needs to be on improving the predictability of concessional financing flows, sustainable financing practices, and alignment with national reform agendas. Similarly, high-impact priorities need to be targeted, including growth-enhancing human capital development and infrastructure. For countries engaged in Fund-supported programs, official bilateral creditors should endeavor to maintain, where feasible, their exposures throughout the program period.

38. Facilitating proactive resolution of debt challenges. Strengthening the debt architecture and ensuring timely, predictable, and efficient processes through the Common Framework and further progress at the Global Sovereign Debt Roundtable (GSDR)[22] should remain a priority. Further coordinated international efforts to secure adequate financial support from bilateral and multilateral partners are also needed to support countries with a strong domestic reform agenda and sustainable debt but facing short-term financing challenges.

39. Scaling up and ensuring well-targeted policy advice and capacity development (CD). Bilateral and multilateral partners should focus CD on strengthening core policy institutions—such as public financial management, debt and investment management, financial supervision and statistics—and on building resilience against shocks. To maximize impact, CD should be well-prioritized, tailored to country needs and absorptive capacity, appropriately sequenced, and closely coordinated among development partners, with strong country ownership. This is particularly important for poorer LICs and FCS, where weaker institutional capacity and governance constraints can limit the effectiveness of concessional financing and the ability to implement robust domestic reforms.

C. A Strong Role for the IMF

40. The IMF continues to play a key role in supporting LICs during this challenging time:

- Through tailored policy advice—in the context of surveillance and lending facilities—and CD, the IMF supports the prioritization, design, and implementation of macroeconomic, financial, and structural reforms. LICs continue to receive the largest share of IMF CD. During FY2022-24,

[22] The GSDR was launched in February 2023 by the IMF, the World Bank, and the G20 Presidency (India in 2023). It has initially focused its work on identifying and addressing key technical bottlenecks in restructuring processes. It has progressively expanded its work to include the prevention of situations of unsustainable debt. It regularly publishes Cochairs Progress Reports, and a Compendium that gathers in one place all technical understandings reached by members since the launch of the GSDR. It issued the "Restructuring Playbook" in April 2025.

around 55 percent of single-country CD was delivered to LICs. In FY2025, fiscal-related CD remained the dominant area of engagement, representing more than 60 percent of total delivery. Support focused on strengthening financial management and revenue administration, with the remainder focusing on other core areas of Fund expertise—monetary policy and capital markets, macroeconomic frameworks, and associated statistical and legal issues. At the same time, the CD portfolio broadened to include emerging priorities—AML/CFT, governance, digitalization, GovTech, and digital money—in line with the evolving challenges confronting member countries (IMF, 2024c; IMF, 2024d), as well as cross-cutting topics such as macroeconomic frameworks.

- The IMF provides financing to help address balance of payments pressures and support macroeconomic stability and sustainable growth, while creating fiscal space for development spending. Sustained demand for Fund financing among PRGT-eligible members suggests significant balance of payments needs persist across LICs. Since March 2020, the IMF has committed SDR 39.5 billion to 57 LICs through the PRGT and the General Resource Account. The 2024 Review of PRGT Facilities and Financing approved a set of reforms to the Fund's concessional lending facilities and an associated funding strategy to preserve the Fund's ability to provide adequate support to LICs over the long term.[23] For those countries facing added challenges from climate change or pandemics, the IMF's Resilience and Sustainability Facility (RSF) can also provide longer-term affordable financing and policy support to build resilience. Since the RSF's inception in 2022, 16 LICs have benefited from RSF arrangements with a total commitment of SDR 5.5 billion. IMF lending and non-financing instruments such as the Policy Coordination Instrument and Staff Monitored Program signal commitment to reforms, which helps catalyze additional public and private financing.[24]

- The IMF plays a leading role on debt issues, in close collaboration with the World Bank. Joint work includes LIC debt sustainability analyses, support to the implementation of the Common Framework, progress at the GSDR, advancement of the "3-pillar approach"—to support countries implementing or committed to substantial growth-oriented reforms, including structural changes and domestic resource mobilization, while facing short-term financing challenges—and implementation of the Debt Management Facility multi-donor trust fund which is key to building debt management capacity.

41. The findings of this report will inform several forthcoming reviews that are advancing the Fund's medium-term priorities set out in the Spring 2025 Global Policy Agenda, as well as help shape the Fund's CD to LICs. The reviews include the Comprehensive Surveillance Review, the

[23] Full implementation of the framework agreed in 2024 will be essential to restore the self-sustainability of the PRGT at a long-term self-sustained annual lending envelope calibrated at SDR 2.7 billion (about US$3.6 billion), more than twice the pre-COVID19 average.

[24] For example, He et al. (2024) find that for LICs, an additional Fund disbursement of 1 percent of GDP is associated with an increase in official development assistance of about 2¾ percent of GDP, half of which comes from multilateral donors. IMF-supported programs can also lower private borrowing costs, with a 1 percent of GDP increase in program size associated with a 23-basis point reduction in borrowing costs (Chahine et al., 2024)

Review of Program Design and Conditionality, and the Review of the Debt Sustainability Framework for Low-Income Countries. The analysis will also contribute to ongoing work on the strategy for CD and the allocation of CD resources to LICs, ensuring that support is better aligned with countries' evolving needs, implementation capacity, and reform priorities.

Box 1. Impact of the New US Tariffs Policy on LICs

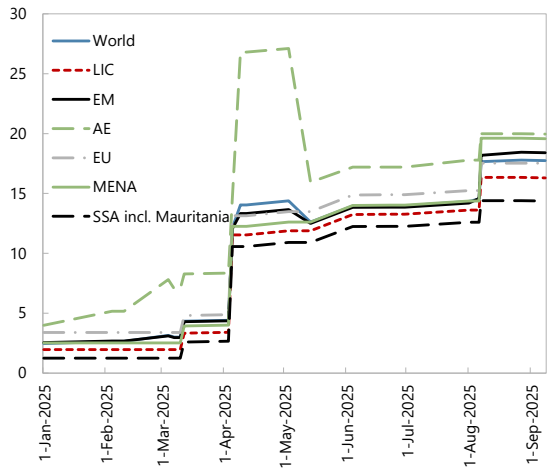
Despite a sharp increase in 2025, average US tariffs on LIC exports remain low with limited aggregate impact. The average effective tariffs applied by the US to imports from LICs rose from 1.2 to 14.4 percent between January and September 2025 (Box Figure 1.1). However, on average, the US absorbs only a small share of LIC exports, where most LICs export raw materials and semi-processed goods that are less targeted by recent tariff measures.

Nevertheless, some LICs are more directly impacted. Those more reliant on the US market and facing significantly higher tariffs than their peers for key exports are likely to be more affected, as export opportunities diminish and vulnerabilities heighten (Box Figure 1.2). For example, higher US tariffs may weigh on exporters of textiles and apparel such as Lesotho, Madagascar, and Bangladesh, where firms may be forced to downsize or redirect exports toward less profitable markets, and benefit LICs facing lower tariffs, such as Honduras. The tariff hikes, combined with uncertainty surrounding the future of preferential trade arrangements such as HOPE-HELP and AGOA, heighten risks to employment and GDP growth in Haiti and parts of SSA. In this context, policies to diversify products and export markets, improve trade facilitation, and deeper regional integration are critical to reducing vulnerabilities to unilateral tariff shocks and strengthening export resilience.

The new US tariff policy could also reinforce a gradual shift in LIC trade patterns toward non-advanced economy partners. The share of LICs exports to the US has declined over time while EMs have become the main trading partner and FDI provider for LICs. China has emerged as the largest individual buyer of raw materials and primary goods and key supplier of manufactured products. The shift in the US trade policy may further accelerate this trend, although it is too early to assess the scale of this long-term reallocation (IMF, 2025g).

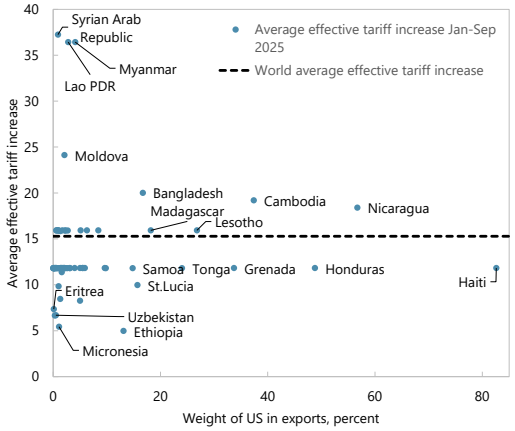
Box Figure 1.1 Average Effective Tariffs

(In percent)



Box Figure 1.2 Average Effective Tariff Increases in LICs

(In percentage points)



Source: WTO-IMF Tariffs Tracker, World Integrated Trade Solution (WITS) database, and IMF staff calculations.

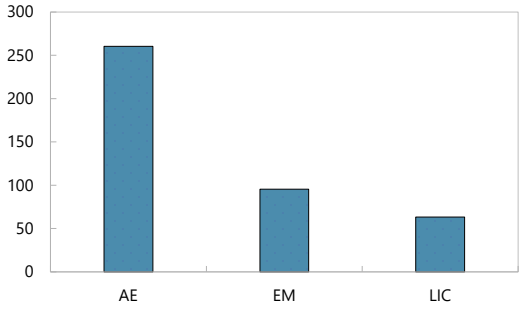
Box 2. Sovereign-Bank Nexus in LICs

LICs face a higher concentration of sovereign debt in domestic banks compared to AEs and EMs (Box Figure 2.1).[1] Over the past decade, banks' holdings of sovereign debt have increased, reaching 15 percent of banking sector assets for the median LIC. These exposures are highly skewed, reflecting the presence of growing extreme exposures, and are especially elevated in frontier LICs and FCS. They are also higher in countries with elevated fiscal financing needs.[2] More limited access to external financing going forward may force LICs to continue relying on domestic banks to meet their fiscal financing needs, further intensifying the already large sovereign-bank nexus.

Box Figure 2.1 Sovereign-Bank Nexus in LICs

Size of Banking Sector

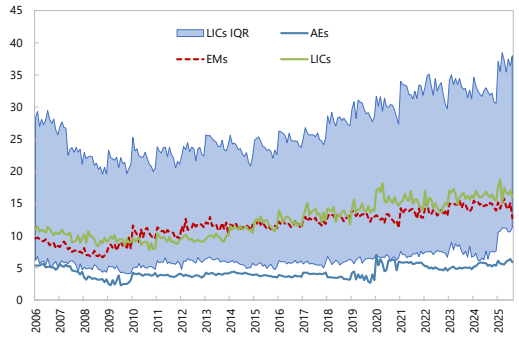
(Total assets of banking sector, in percent of GDP, 2024, median)



Source: IMF Monetary and Financial Statistics, WEO and IMF staff calculations.

Sovereign-Bank Nexus

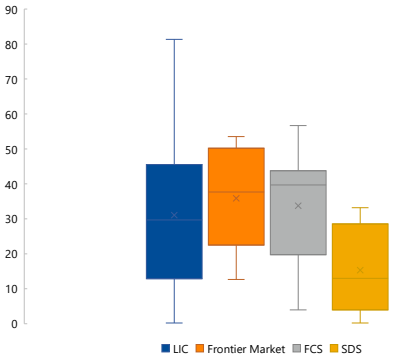
(Total claims on sovereign in percent of total assets)



Source: MFS and IMF staff calculations.
Note: Total claims on sovereign = Claims on central government + SOEs + local/state governments, includes obligations denominated in both domestic and foreign currency.

Heterogeneity of Banking Sector's Claims on Central Government in LICs

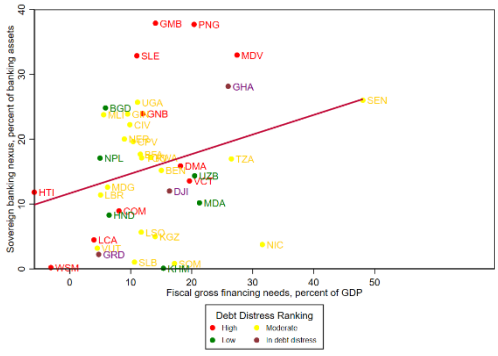
(In percent of banking sector assets, end-June 2025)



Sources: IFS, IMF staff calculations.
Note: Due to data limitation, the sample in this chart includes 34 LICs, of which 9 are classified as frontiers, 8 FCSs, and 11 SDSs.

Sovereign-Bank Nexus and Fiscal GFN

(LICs by debt distress ranking, 2024)



Source: IDS, IMF Fiscal Monitor; IMF staff calculations.
Note: Zambia and Mozambique are dropped from the sample as outliers. Zambia's fiscal GFN is 85.56 percent of GDP with 24.98 percent sovereign exposure; Mozambique's fiscal GFN is 152.93 percent of GDP with 23.83 percent sovereign exposure.

Box 2. Sovereign-Bank Nexus in LICs (concluded)

A two-way transmission of risks exists between rising sovereign debt risks and the soundness of the banking sector. Sovereign stress is easily transmitted to the banking sector when sovereign-bank linkages are strong. IMF DSAs show that LICs where banks hold the highest shares of sovereign debt also tend to be classified as facing high risk of debt distress or already are in debt distress. Should stress spill over to the banking sector, it would constrain the already limited availability of private credit and dampen economic growth. Other ramifications include capital outflows and pressures on the foreign exchange market that could in turn exacerbate fiscal challenges. Alternatively, banking sector deterioration negatively affects the sovereign risk premium and banks' demand for sovereign debt, exacerbating sovereign debt risk. However, with average total banking sector assets at around 63 percent of GDP, banks in LICs are relatively small and less interconnected compared to banks in AEs and EMs, pointing to limited international spillovers.

Policy efforts should aim to reduce banks' excessive sovereign exposure while safeguarding financial stability. Priorities include stronger prudential oversight, introducing risk-based capital requirements for sovereign holdings, and improved disclosure to limit regulatory arbitrage. Supervisors should use stress tests to assess sovereign-related vulnerabilities and ensure adequate capital buffers. Over time, deeper domestic markets, better debt management, and strengthened bank-resolution and governance frameworks—especially for state-owned banks—will help weaken the sovereign–bank nexus and build resilience.

[1] The sovereign-bank nexus risk is reflected in the share of total claims on the government—including central and local governments as well as state-owned enterprises—expressed as a percentage of the banking sector's total assets.
[2] Fiscal gross financing need (GFN) is defined as the sum of overall fiscal deficit, debt amortization and arrears clearance.

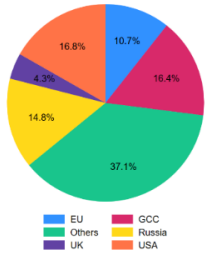
Box 3. Remittances in LICs: Vital but Vulnerable Inflow

LICs remain exposed to immigration policy changes in advanced economies, which could weigh on future remittance inflows. Roughly 17 percent of remittances to LICs originate from the United States, 11 percent from the European Union, and 4 percent from the United Kingdom (Box Figure 3.1).[1] Despite several host countries tightening their immigration policies, remittances to LICs have remained robust. For example, Honduras and Nicaragua saw remittance inflows rise by about 20-25 percent in 2025. However, this surge has likely reflected precautionary transfers amid uncertainty, rather than labor market strength, as U.S. Hispanic unemployment increased. The uptick in remittances is expected to unwind from 2026 as the impact of stricter U.S. immigration policies and a new tax on outgoing remittances begin to outweigh additional transfers from remaining migrants, leading to a gradual decline in remittances as a share of GDP (Box 1.2, WHD REO).

New transfer methods—including mobile money and crypto—can help lower fees and partially mitigate the impact of tighter immigration policies. (Box Figure 3.2) The G20 Roadmap for Enhancing Cross-Border Payments targets a reduction in average retail payment fees to below 1 percent and remittance fees to below 3 percent of transfers by 2027 and 2030, respectively.[2] In country-pairs where mobile money is already used for remittances, fees have averaged about 3 percentage points. Based on the elasticity estimated by Cerutti, Firat, and Perez-Saiz (2025), lowering average fees from 4.5 percentage points to the level of mobile money fees would raise remittances by 2.5 percent.

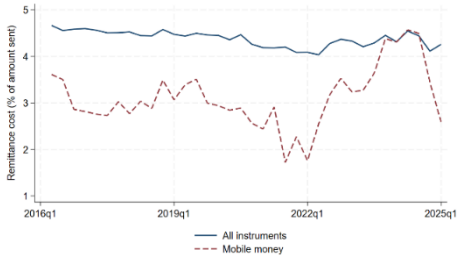
At the same time, the growing use of crypto-assets for cross-border transfers poses new risks. Such crypto-related inflows—encompassing unbacked crypto-assets and stablecoins—are increasing and can reach a few percent of GDP. Although data limitations prevent disentangling different types of crypto flows, evidence shows that cryptocurrencies are increasingly used to send remittances and to evade capital controls in developing countries (Graf von Luckner et al., 2023). While crypto-assets can enhance cross-border payments by reducing transaction costs and settlement times, large and volatile flows can amplify balance of payments pressures, facilitate circumvention of AML/CFT frameworks, and contribute to "cryptoization," which undermines monetary sovereignty.

Box Figure 3.1 Remittance Inflows to LICs by Source
(In percent of total)



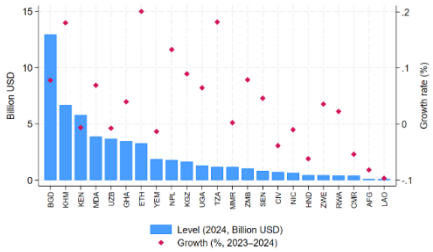
Sources: KNOMAD/World Bank Bilateral Remittance Matrix 2021, December 2022; IMF staff calculations

Box Figure 3.2 Remittance Costs to Low-Income Destinations
(Average, in percent)



Sources: World Bank Remittance Prices Worldwide database, IMF staff calculations

Box Figure 3.3 Crypto-Related Inflows to LIC Destinations
(Level (2024) and growth (2023-2024))



Sources: Cerutti, Chen, and Hengge (IMF, 2024), IMF staff calculations.

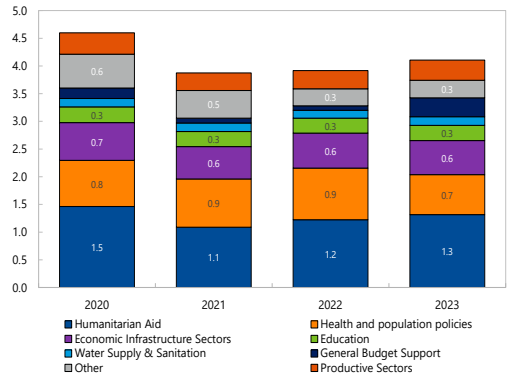
[1] KNOMAD/World Bank Bilateral Remittance Matrix 2021, December 2022.
[2] Financial Stability Board. 2023b. "G20 Roadmap for Enhancing Cross-Border Payments: Consolidated Progress Report for 2023". Financial Stability Board, Basel, Switzerland.

Box 4. ODA for LICs

ODA is designed to ease financing constraints in LICs and support high-return social and infrastructure investments. It tends to be more effective where macroeconomic policies and governance are sound (Burnside and Dollar, 2000) and when directed to the poorest countries and investments such as infrastructure and health (Galiani et al., 2017). At the same time, large and persistent ODA inflows can weaken incentives to mobilize domestic revenue, increase rent-seeking, and shift spending toward current outlays rather than high-return investment, especially where institutions are weak. Consequently, the growth and development impacts of concessional flows increasingly depend on their quality, targeting, and domestic policies in recipient economies.

Box Figure 4.1 Sectoral Distribution of Net ODA Flows to LICs

(In percent of GDP)



Sources: TOSSD database and IMF staff calculations.

Declines in ODA flows raise important concerns and donors should prioritize preserving humanitarian flows and, more broadly, aid directed to the poorest and fragile LICs. More than half of ODA flows to LICs are currently delivered through the public sector, followed by multilateral organizations and NGOs, and to a lesser extent, teaching and private institutions (based on staff calculations using OECD CSR data). Consequently, lower flows are likely to have direct implications for government budgets, public investment, and service delivery. TOSSD data suggest that, if the distribution of flows across countries and sectors remains as observed in 2023, social sectors and humanitarian aid—both heavily reliant on external financing—would be particularly exposed to ODA cuts (Box Figure 4.1).[1] The impact is likely to be most acute in countries with limited fiscal space and weak domestic revenue bases, where public investment and essential services rely heavily on externally financed projects. Given their reliance on ODA, the impact would be disproportionately high in the poorest LICs and FCS. The projected decline in ODA bilateral flows from the OECD data shared with IMF staff implies a 1.1 percent of GDP financing loss for both the poorest LICs and FCS, amplifying risks to essential service delivery and undermining longer-term development outcomes. Moreover, the expected decline in ODA flows may weaken reserve accumulation in aid-dependent countries.

In addition, the ongoing shift toward more project support, and from grants to concessional loans, underlines the need for improving public investment management and debt management. Several key ODA providers have already engaged or announced a significant shift toward an "investment partnership" approach. In fact, within the ODA flows to the public sector in LICs, project-type interventions already dominate (around three-quarters of the total), and budget support accounts for less than 20 percent, with the remainder taking the form of experts, technical assistance, and debt relief (based on staff calculations on OECD CSR data). However, the continuation of this shift away from budget to project support, and from grants to concessional loans, will likely impact some countries more than others, while requiring from all LICs further efforts to improve public financial management, including investment and debt management. Continued progress in domestic revenue mobilization will also be key.

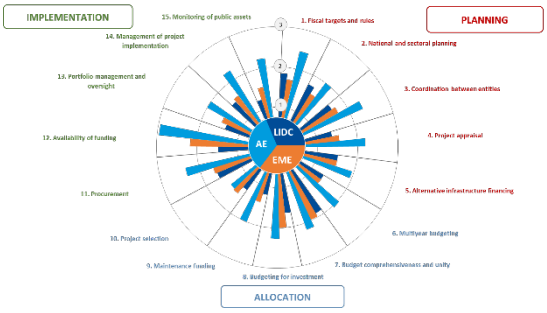
1/ However, that there are definitional and conceptual differences between TOSSD concessional data and the ODA definition.

Box 5. Organizing Public Investment Management (PIM) in LICs in a Tighter Financing Environment

Efficient public investment is essential for translating borrowing into high-quality projects in the context of a tighter financing landscape for LICs. Strengthening PIM systems can improve investment efficiency, raise growth payoffs, and ensure that scarce—often debt-financed resources—deliver durable development outcomes and raise returns on investment. This is especially important for LICs, where recent analysis on the IMF's PIM assessment (PIMA) data finds LICs' institutional design and effectiveness of public investment—across all three phases of the project cycle: planning, allocation, and implementation—are one-third of the level found in the rest of the world (Box Figure 5.1). The following areas are highlighted as PIM reform priorities for LICs:[1]

Box Figure 5.1 PIMA Effectiveness Scores by Institution and Income Group

(PIMA scores)



Sources: IMF PIMA scores and IMF staff calculations.

- *A Strategic Project Pipeline as the Single-Entry Point for Public Investment*. LICs should maintain a country-owned, rolling project pipeline linked to national development and sector plans. The pipeline ensures that, regardless of funding sources or modalities, projects are chosen based on national priorities and have met standardized quality thresholds.

- *Appraisal and Selection*. Robust project appraisal is essential to assess the strategic relevance, expected costs and benefits, and implementation readiness of investment projects. Appraisals should be conducted systematically for all major projects, and only those meeting the required standards should be included in the pipeline. Project selection should be based on published criteria, including strategic alignment, expected economic and social returns, and economic resilience-building potential.

- *Implementation of Projects*. Open and transparent procurement is essential to realizing the benefits of project financing, mitigating corruption risks, and maintaining investor confidence. In many LICs, capital budgets are often used as fiscal buffers, leading to cash rationing, arrears, and implementation delays or even project abandonment. Unreliable government co-financing or delayed viability-gap payments can trigger contractual disputes. Strengthening portfolio-monitoring systems that track physical progress, disbursements, and risk indicators can help governments better manage implementation risks.

- *Dedicated Institutional Capacity for Project Preparation and Risk Management*. LICs need dedicated institutional capacity to prepare, assess, and manage investment operations. This includes central units for project preparation and technical support, typically located in the Ministries of Finance or Planning and functioning as PIM gatekeepers. Where more sophisticated approaches such as project finance are envisaged, adequate commercial and financial expertise must also exist within governments to diligently monitor contracts and manage associated risks.

[1] Khaled Eltokhy, Nicoletta Feruglio, Kezhou Miao, Arturo Navarro, and Eivind Tandberg, (2024), "Public Investment Management Bottlenecks in Low-income Countries." IMF Working Paper 24/232, International Monetary Fund, Washington, DC.

SECTION II: ATTRACTING INVESTMENT IN UNCERTAIN TIMES: FISCAL POLICY AND INSTITUTIONAL DRIVERS OF FDI IN LOW-INCOME COUNTRIES[25,26]

A. Introduction

42. FDI can generate substantial macroeconomic benefits for host countries by financing productive investment, transferring technology, diversifying exports, and creating jobs. [27] A large empirical literature documents its positive impact on growth when supported by sound policy and institutional frameworks (Borensztein, De Gregorio, and Lee 1998; Alfaro et al. 2004; Blonigen and Wang 2005). Past experience also illustrates its potential contribution to development: for example, countries that graduated from the IMF's PRGT—mostly between 2009 and 2014—attracted higher FDI inflows (as a percent of GDP) than current LICs and achieved higher overall investment in the period between the mid-2000s and mid-2010s (Figure 22). These inflows likely supported capital accumulation, productivity gains through technology and managerial spillovers, deeper export integration, and employment growth. However, if not well managed, FDI can also entail risks, including the displacement of domestic firms and environmental degradation, with implications for inclusive growth and climate objectives. FDI is not unambiguously benign. Profit repatriation, intragroup transactions, and shifts in corporate deposits can weigh on the current account; while FDI-related financial flows can amplify BOP pressures in times of stress through deleveraging, liquidity outflows, and/or reduced reinvestment.[28]

[25] Aiko Mineshima (lead), Isabela Duarte, Arika Kayastha, and Ezgi Ozturk (all F2) and Francisco Vazquez (F1), under the guidance of S. Ali Abbas and Yuko Kinoshita (both FAD). Arika Kayastha provided research analysis support for the paper; Mitali Das and Davide Furceri offered suggestions to strengthen the robustness of the empirical results; and participants at an FAD seminar contributed helpful suggestions.

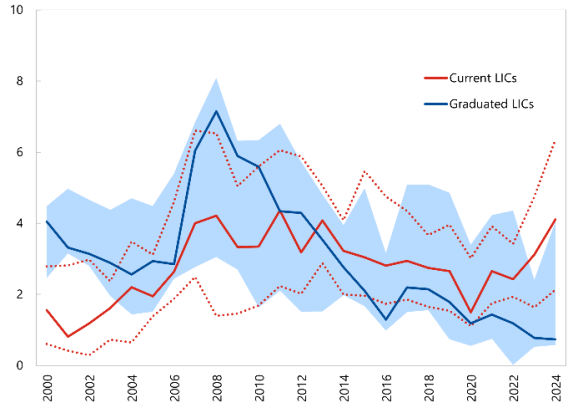
[26] Low-income countries are defined in this report, as in Section I, as the 70 countries eligible for the Poverty Reduction and Growth Trust (PRGT) facilities. This group can further be divided by income level, institutional characteristics, and export structure, to highlight the significant heterogeneity within the group (Annex I).

[27] The section draws on three FDI data sources: balance of payments (BoP) statistics, the World Bank's Harmonized Bilateral FDI (HBFDI) database, and Orbis project-level data. BoP and HBFDI capture total FDI flows—including greenfield investment and mergers and acquisitions (M&A)—while the analysis of FDI quality relies on Orbis data and is restricted to greenfield projects only. In LICs, cross-border M&A account for a relatively small share of total FDI (around 10 percent), suggesting that their inclusion is unlikely to materially affect the section's key findings.

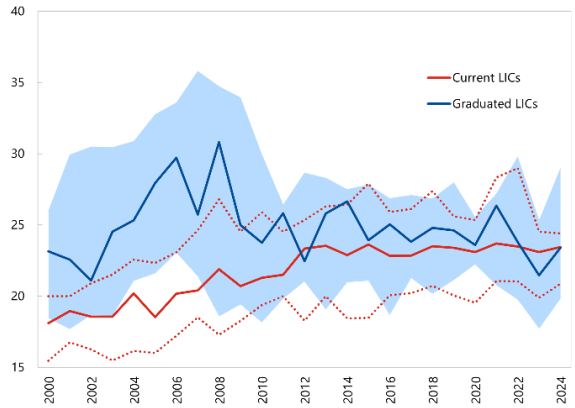
[28] For example, in Mongolia, profit repatriation and intragroup financial flows from large mining FDI projects contributed to income-balance outflows and current account pressures following commodity price downturns (IMF, Mongolia Article IV Staff Reports, 2023, 2025). In Mozambique, LNG-related FDI generated large import and income outflows with limited short-term spillovers, increasing external vulnerabilities during stress episodes (IMF, Mozambique Article IV Staff Reports, 2019). More broadly, during the Global Financial Crisis and the COVID-19 shock, declines in reinvested earnings and withdrawals of multinational corporate deposits amplified balance-of-payments pressures in several emerging and low-income countries.

Figure 22. Gross FDI Inflows and Total Investment in Graduated LICs vs Current LICs

FDI Inflows
(In percent of GDP)



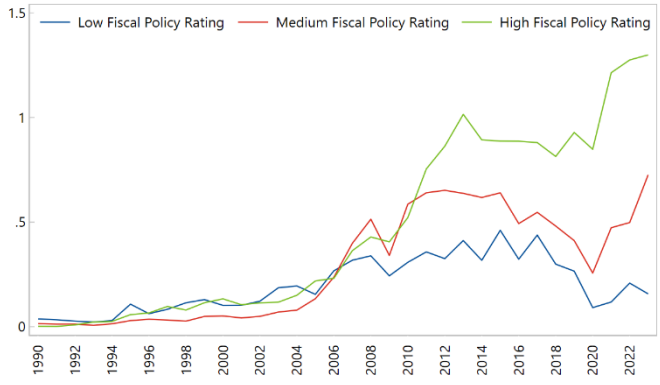
Total Investment
(In percent of GDP)



Source: World Economic Outlook, IMF BOP Database, IMF staff calculations.
Note: Graduated LICs are the 13 countries that have transitioned out of their PRGT eligibility: Albania 2009, Angola 2009, Armenia 2012, Azerbaijan 2009, Bolivia 2014, Georgia 2012, Guyana 2019, India 2009, Mongolia 2014, Nigeria 2014, Pakistan 2009, Sri Lanka 2009, Vietnam 2014. Both graduated LIC and current LIC samples are unchanged over time for this exercise. Median values are presented with solid lines, with dashed lines and shaded areas show the middle tercile of the distribution.

43. The recent global retreat in FDI, together with significant divergence across LICs, warrants an investigation into pull-factors for FDI, notably domestic policies and institutions. As noted in Section I, and by the World Bank (2025) (see Annex V), FDI inflows into EMDEs have not kept pace with economic growth, amid weaker trade integration and rising policy uncertainty, underscoring the growing role of policy credibility and institutional strength in sustaining and improving FDI inflows. FDI inflows into LICs have declined from nearly 4 percent of GDP in 2012 to about 2.4 percent in 2023, reflecting weaker growth prospects in host and source economies, tighter financial conditions, policy uncertainty, and rising geopolitical risks (World Bank 2025; UNCTAD 2024). Performance, however, has been quite heterogeneous, as evinced by the wide band around the median LIC path in Figure 22; and the significant divergence in FDI volumes (in US dollar) received by LICs with high, medium and low fiscal policy rating (per the World Bank's Country Policy and Institutional Assessment (CPIA), Figure 23). The foregoing merits a focus on the role of differences in host country "pull" characteristics, especially fiscal policy and institutions, that lie within the government's control.

Figure 23. Gross FDI Inflows to LICs by CPIA Fiscal Policy Rating
(Billion US dollar)



Source: IMF BOP Statistics and World Bank CPIA Database.
Note: LICs are grouped into three time-invariant categories based on their historical average CPIA fiscal policy ratings: low (below the 33rd percentile), medium (33rd–66th percentile), and high (above the 66th percentile).

44. Among the many determinants of FDI, fiscal policy stands out as one of the few levers that governments in LICs can directly influence and that has a clear bearing on investors' risk-adjusted returns. Investors calculate risk-adjusted returns by factoring in macroeconomic instability, policy reversals, and exchange-rate depreciation—risks that often arise in the context of fiscal or balance-of-payments stress. Sound fiscal discipline and strong fiscal institutions—anchored in sustainable debt paths, credible medium-term frameworks, and effective public financial management—reduce these risks by enhancing policy predictability and resilience. By contrast, weak fiscal discipline and institutions amplify uncertainty and raise perceived investment risk, even when underlying returns are high, motivating this section's focus on fiscal policy as key FDI pull factors in LICs.

45. Against this backdrop, the section sets out major recent trends in FDI inflows into LICs, empirically examines the role played by fiscal pull factors, and discusses key attendant reforms:

- **Subsection B** unpacks key features of FDI inflows received by LICs since the turn of the millennium, building on the high-level stylized facts presented in Section I. It does so, by zooming in on the size of FDI inflows received by LICs (in relation to EMs and AEs); shifts in the origin of FDI (i.e., source countries); host-country characteristics, with a focus on differences across export structures; and FDI quality, assessing sectoral composition and R&D intensity of FDI-funded projects.

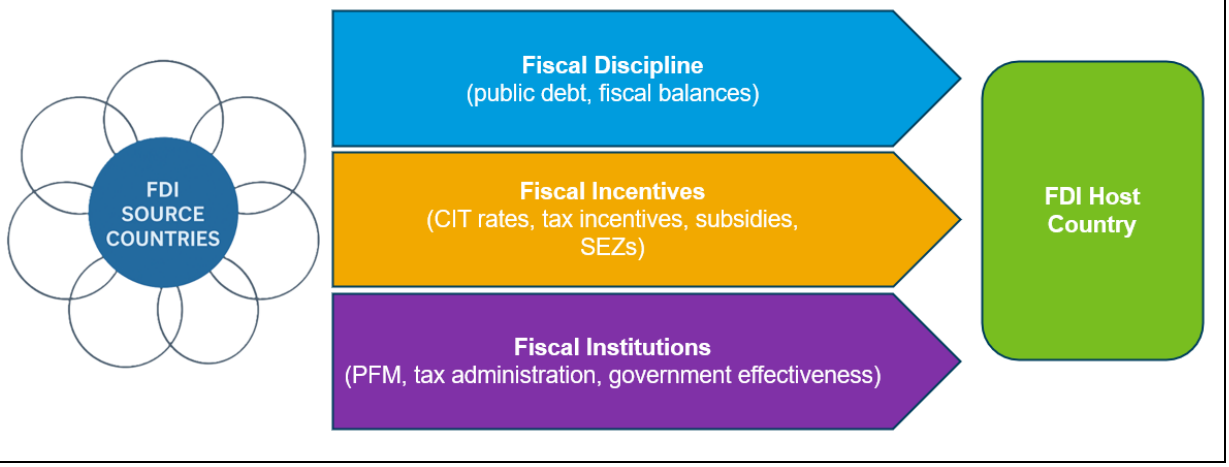
- **Subsection C** introduces three sets of fiscal pull factors—fiscal discipline (e.g., public debt-to-GDP ratio, fiscal sustainability indicators), fiscal incentives (e.g., tax rates, SEZs), and fiscal institutions (notably in revenue administration and PFM) that, in light of existing research, are likely to affect FDI (Figure 24). A fourth bucket of broader institutional and business settings is also presented.

- **Subsection D** undertakes a detailed econometric investigation of the role of the factors identified in Section C using gravity and local projections models, drawing out comparisons with EMs, drivers of higher quality FDI, and the dynamics effects of changes in fiscal incentives (e.g. introduction of an SEZ).

- **Subsection E** presents four country case studies illustrating how reforms to revenue administration and public financial management have coincided with changes in FDI inflows across different institutional settings, highlighting both potential gains and persistent implementation constraints.

- **Subsection F** sets out key reforms on fiscal management, tax and subsidy design, and SEZ frameworks, alongside strengthened fiscal institutions and governance, that LIC authorities can target to attract more and better-quality FDI, while protecting scarce government revenues and economic competitiveness.

Figure 24. Fiscal Drivers of FDI Inflows



46. The section contributes to existing research by updating the somewhat dated literature on fiscal pull factors for FDI (using new data sources), focusing on LICs vs. EMs, and examining how the importance of fiscal levers varies under different uncertainty regimes and dynamic impacts of fiscal incentives on FDI. First, it revisits the literature on fiscal determinants of FDI by incorporating newer data that shed light on fiscal institutions and administrative capacity, including the International Survey on Revenue Administration (ISORA). Much of the earlier literature examines fiscal pull factors primarily through policy parameters such as statutory tax rates, tax differentials, and investment incentives, often with limited attention to how fiscal institutions and administrative capacity shape the implementation, credibility, and durability of these policies—an issue that is particularly salient in LICs (Hines 1996; Devereux and Griffith 1998; Desai, Foley, and Hines 2004; Büttner and Ruf 2007). Within this literature, Klemm and Van Parys (2012) show that investment tax incentives—such as tax holidays and special economic zones—can raise FDI inflows, but do not increase total investment or growth, implying that the FDI response may reflect crowding out of domestic investment or changes in ownership rather than new capital formation. Second, while recent studies—including the World Bank (2025)—underscore the importance of macroeconomic stability, institutional quality, and trade integration for attracting FDI across EMDEs, they give relatively limited focus on LIC-specific fiscal capacity constraints.[29] By centering the analysis on LICs, this section complements the EMDE-focused evidence. Third, the section assesses whether the importance of fiscal discipline and fiscal institutions for FDI varies across periods of heightened uncertainty, shedding light on the role of policy credibility and institutional strength in shaping investor responses under more volatile global conditions. Finally, moving beyond static associations, the section provides, to our knowledge, the first attempt on the dynamic responses of

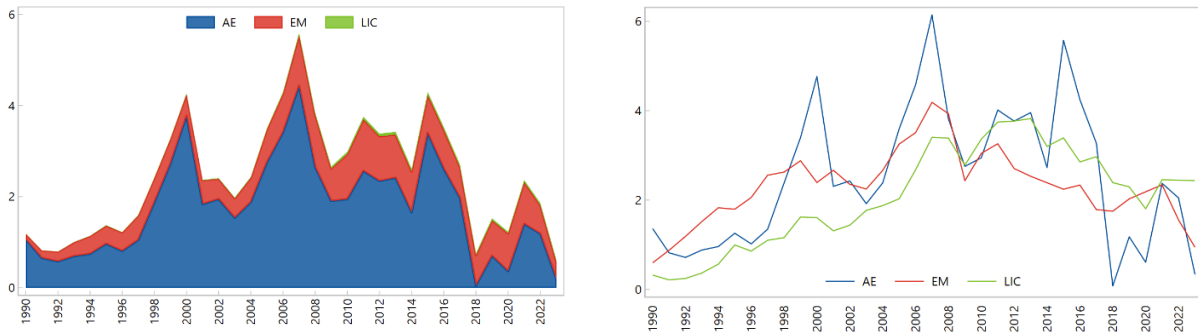
[29] A large and influential literature emphasizes non-fiscal institutional fundamentals—such as governance, rule of law, regulatory quality, and political stability—as key determinants of FDI, often abstracting from the specific role of fiscal institutions and policy execution (North 1990; Wheeler and Mody 1992; Globerman and Shapiro 2003; Busse and Hefeker 2007; Kinoshita and Campos 2002).

FDI to fiscal policy changes in LICs using local-projection methods, tracing how FDI evolves over time following reforms in fiscal incentives and implementation.

B. FDI in LICs: Small Flows, Changing Sources, Declining Quality

47. FDI continues to play a limited quantitative role in LICs despite their greater need for stable external financing to finance productive investment, transfer technology, diversify exports, and create jobs. Global FDI inflows fell sharply during the 2008–09 global financial crisis and, after a brief recovery, have remained subdued since 2018[30]. Recent analyses attribute this persistence to several global developments: rising geopolitical tensions in key regions, a slowdown in global value chain expansion, increased use of industrial policies and onshoring initiatives in advanced economies, tighter global financial conditions, and a sharp contraction in cross-border investment during the COVID-19 pandemic (World Bank 2025; UNCTAD 2024). In relative terms, LICs experienced a somewhat smaller decline than advanced economies (AEs) and EMs during major global downturns, and their FDI inflows as a share of GDP have often been comparable to—or at times slightly higher than—those of other income groups (Figure 25, right). This pattern largely reflects the small economic size of LICs, where modest project inflows translate into higher ratios. However, in absolute terms, LICs continue to account for less than 1 percent of global FDI, leaving the scale of investment far too limited to meet their development and diversification needs.

Figure 25. Global FDI Inflows by Income Group



Sources: IMF BoP Statistics, World Economic Outlook, and IMF staff calculations.
Notes: The left panel shows FDI inflows by income group expressed as a percent of global GDP. The right panel shows FDI inflows by income group expressed as a percent of the respective group's GDP.

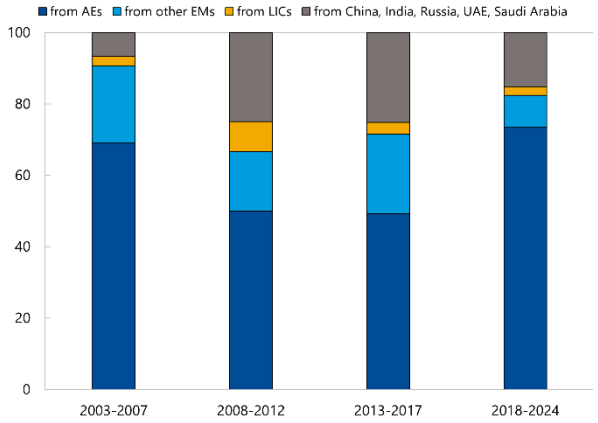
48. The composition of countries from which FDI to LICs is "sourced" has shifted since the early 2000s, with a sharp post-GFC rise in the share of China, India, and Gulf countries, now partially unwound. In the early 2000s, most FDI to LICs originated from AEs, but this share declined steadily through the mid-2010s as major EMs—especially China and India, along with Russia, the

[30] The decline in 2018 largely reflected U.S. tax reform (TCJA), which triggered significant repatriation by U.S. multinationals and lowered FDI to AEs. Europe saw particularly steep reductions—at times exceeding 70 percent—linked to the unwinding of pass-through investment and shifts in intracompany financial flows (UNCTAD 2019).

UAE, and Saudi Arabia—expanded their footprint (Figure 26, left). In recent years, however, the AE share has begun to rise again, driven by renewed investment by U.S. and European firms in mining, services, finance, and telecommunications; the post-pandemic recovery of cross-border investment from AEs; and a tapering of large EM-led projects, particularly in resource sectors. At the individual country level, the U.S. and China are the two largest individual source countries, followed by Norway, the United Kingdom, Canada, Thailand, and France (Figure 26, right).

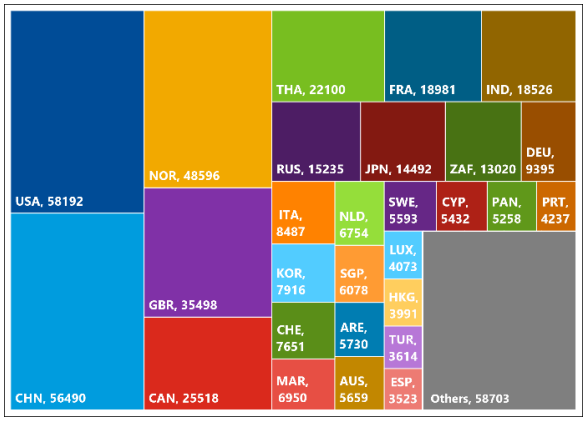
Figure 26. LICs: FDI Sources

By Source Country Group



By Source Country

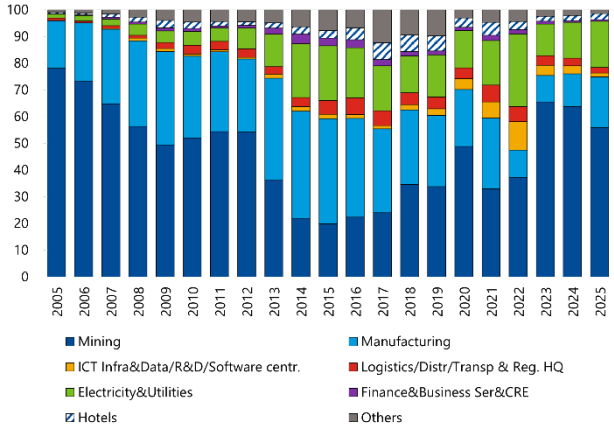
(Cumulative, 2012-24, millions of US$)



Sources: Orbis Cross-border Investments and IMF staff calculations.
Notes: The left chart shows the share of FDI from each country group averaged over the respective period. The right chart shows the cumulative FDI between 2012 and 2024 to LICs from country-specific sources. Orbis data reflects gross FDI investment amounts for greenfield sector projects including both announced and completed projects.

49. The sectoral composition of LIC FDI has also evolved, with the share of mining declining through the mid-2010s before rebounding in recent years (Figure 27). Mining historically dominated LIC FDI inflows, but its share fell as global commodity prices softened and investors shifted toward manufacturing and electricity and utilities, supported by supply-chain expansion, rising energy needs, and infrastructure investment (IMF 2025h; World Bank 2023). Since the late-2010s, however, mining has regained momentum, reflecting renewed interest in critical minerals and new extractive projects, while investment in ICT and data-related activities has risen gradually from a low base. By contrast, tourism-related FDI has continued to shrink as tourism-dependent LICs face growing competition

Figure 27. LICs: FDI Inflows by Sector



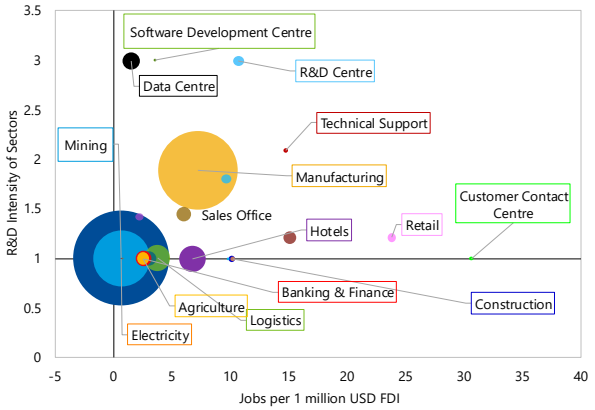
Sources: Orbis Cross-border Investments and IMF staff calculations.
Data covers greenfield FDI only.

from alternative destinations offering upgraded facilities, stronger transport connectivity, or lower climate-related vulnerabilities (World Bank 2023; UNCTAD 2022).

50. FDI to LICs tends to be concentrated in low-R&D-intensive and less job-creating activities, limiting its broader developmental impact. Not all FDI-funded projects deliver the same macroeconomic benefits, and outcomes can vary by sector and project type. Capital-intensive investments—most notably mining and electricity, which together account for the largest share of FDI inflows to LICs—generate sizable export earnings and fiscal revenues but create relatively few permanent jobs (Figure 28, left). By contrast, FDI projects in hotels and logistics are more labor-intensive and generate more employment, but their R&D intensity is generally low. Manufacturing, the second-largest recipient of FDI in LICs, offers a more balanced profile, combining relatively higher job creation with greater potential for skills transfer and domestic supply-chain linkages. FDI projects in LICs remain far less R&D-intensive than in EMs: more than 80 percent of LIC projects are in low-R&D activities, compared with about half in EMs (Figure 28, top right). This gap is not driven solely by sectoral composition; even within manufacturing, only about one-third of LIC projects are high-R&D, versus roughly 60 percent in EMs (Figure 28, bottom right).

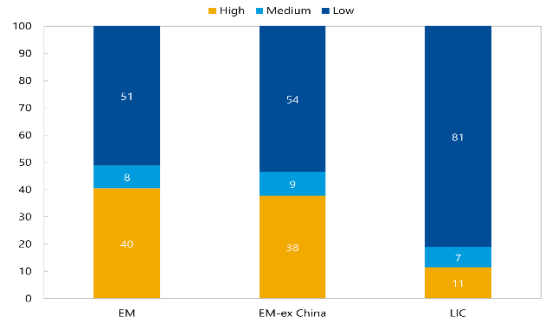
Figure 28. Quality of FDI Projects

LICs: FDI by R&D Intensity and Job Creation



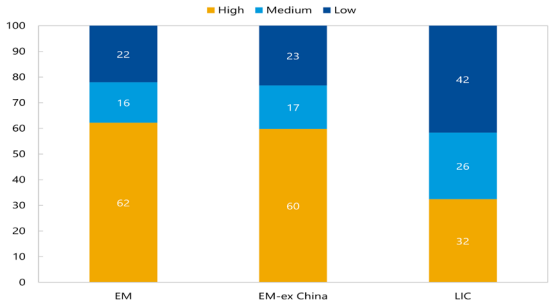
FDI by R&D Intensity: All Sectors

(In percent of total)



FDI by R&D Intensity: Manufacturing

(In percent of total)



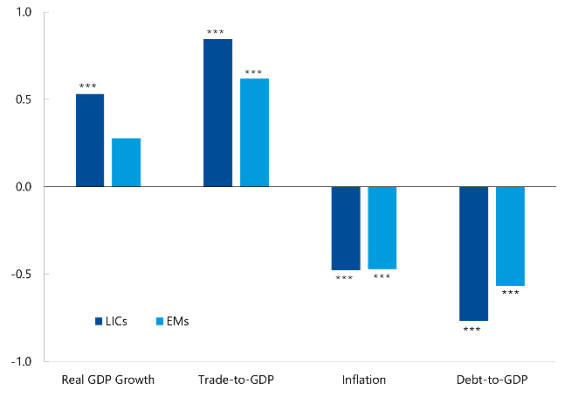
Sources: Orbis Cross-border Investments and IMF staff calculations.
Notes: In the left figure, R&D intensity is rated on a scale from 1 to 3, with 1 indicating sectors with the lowest R&D intensity and 3 indicating those with the highest, based on the OECD Taxonomy of Economic Activities Based on R&D Intensity. Within each sector, subsectors may carry different classifications; in such cases, the average intensity score is computed by weighting subsectors by their FDI volume. The size of the bubbles reflects the amount of FDI (in US dollars) LICs receive in each sector, illustrating their relative quantitative importance.

C. Identifying Key Domestic Pull Factors for FDI in Light of Existing Research

51. Consistent with the analysis on the impact of sovereign ratings on FDI in Annex III, we would expect good fiscal discipline to be a key anchor for FDI investor confidence. Prudent fiscal discipline—reflected in sustainable public debt levels and credible medium-term fiscal paths—helps contain perceptions of sovereign risk and reassures investors that financing pressures are unlikely to translate into abrupt policy reversals. Well-designed fiscal rules and medium-term fiscal frameworks further strengthen credibility by limiting procyclical policy shifts and enhancing the transparency and accountability of budget decisions. Sound fiscal discipline also supports broader macroeconomic stability, including low and stable inflation, which reduces uncertainty and reinforces confidence in the operating environment. Together, these elements contribute to more predictable policy trajectories and lower risk premiums. LICs with credible fiscal anchors are therefore perceived as less likely to accumulate arrears, impose distortionary tax measures, or resort to inflationary financing—developments that typically deter foreign investment. Consistent with this interpretation, LICs with lower average inflation, lower debt-to-GDP ratios, the presence of fiscal rules, and higher ratings for fiscal discipline tend to be associated with greater FDI (Figure 29), underscoring the importance of fiscal discipline as a key pull factor for private investment.

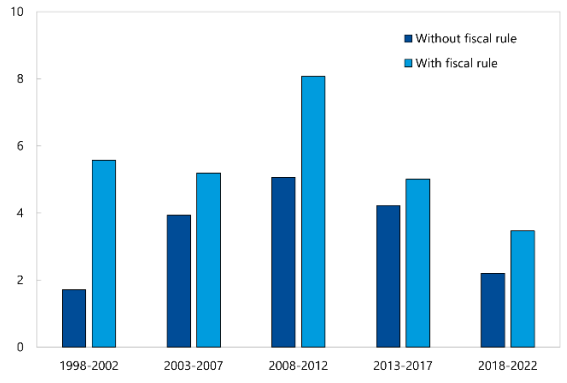
Figure 29. FDI Inflows and Macro-Fiscal Discipline

LICs: FDI and Macroeconomic and Fiscal Indicators



LICs: FDI and Fiscal Rule

(In percent of GDP)



Sources: IMF WEO (April 2025), IMF BoP statistics, IMF. Fiscal Rules Dataset, World Bank Country Policy and Institutions Assessment (CPIA), and IMF staff calculations.
Notes: The eft chart presents correlations between annual average FDI-to-GDP ratios and real GDP growth, trade (sum of exports and imports) as a share of GDP, headline inflation, and public debt as a share of GDP. *** denotes statistical significance at 1 percent level.

52. Next are fiscal incentives (like tax incentives, subsidies or SEZs) designed specifically to attract and shape FDI. Faced with persistent structural constraints—such as infrastructure gaps, limited human capital, and governance weaknesses—many LICs have relied on fiscal tools, including

tax incentives, subsidies, regulatory reforms, and SEZs, to enhance their investment appeal.[31] While these incentives could potentially help address specific cost or risk factors faced by investors, their impact varies widely across policy types and country contexts and is far from automatic.

- **Tax incentives.** Tax regimes—such as profit-based tax incentives (such as tax holidays and reduced rates) and cost-based measures (such as accelerated depreciation and investment allowances)—can influence investment decisions (Abbas & Klemm, 2013; Devereux & Griffith, 1998; Büttner et al., 2004), but the literature generally finds that profit-based tax incentives on their own have only a modest effect on attracting FDI—particularly in LICs and EMs where fundamentals such as infrastructure, macroeconomic stability, governance, and human capital remain weak (IMF, 2015; James, 2013; World Bank, 2025). Many LICs have relied heavily on tax incentives—for example, Ghana, Tanzania, and Mauritania[32] offer multi-year corporate income tax (CIT) holidays, while Liberia and Sierra Leone provide extensive CIT exemptions and import-duty waivers for large investment projects. In several cases, these incentives have generated substantial revenue costs with limited additional investment, reflecting the tendency for firms to invest based primarily on market potential and operating conditions rather than statutory tax rates alone. Moreover, the effectiveness of aggressive tax competition is expected to diminish under the 15 percent global minimum corporate tax (OECD Pillar 2), which reduces the value of very low statutory CIT rates for multinational investors.

- **Subsidies.** Well-designed, time-bound, and targeted cost-based incentives—such as accelerated depreciation, investment allowances, wage or training subsidies, or direct support for investment-related capital costs—can lower the user cost of capital and encourage FDI, particularly in manufacturing and other capital-intensive sectors. Several LICs have adopted such measures. Ethiopia has provided subsidized industrial land, government-financed factory shells, and preferential utility tariffs to attract light manufacturing projects. Rwanda has used training subsidies and co-financing for enabling infrastructure to support investors in ICT, logistics, and tourism. Uganda and Tanzania have offered subsidized land leases and publicly built industrial facilities to encourage agro-processing and light industry. Empirical studies find that well-targeted cost-based incentives can raise FDI inflows (Harding & Javorcik, 2011; Katitas et al., 2024), and theoretical work shows that such incentives may be more effective than across-the-board corporate tax cuts (Tian, 2018). Nonetheless, their impact is typically modest and context-dependent, and they are most effective when accompanied by broader improvements in infrastructure, governance, and the investment climate. In addition, the fiscal cost of non-tax incentives—such as subsidized land or publicly provided facilities—is not always transparently

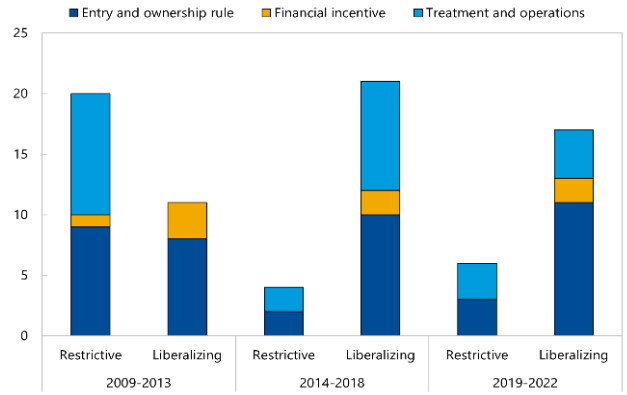
[31] For example, Ethiopia has recently implemented reforms such as easing foreign exchange rules, opening sectors previously closed to foreign investment, like banking, to foreign investment, and creating special economic zones to attract FDI. In response to investor concerns, the government has prioritized issuing comprehensive customs and tax manuals to improve transparency and predictability in revenue administration. As a result, recent FDI agreements from 2025 totaling $1.6 billion highlight the country's potential for growth. For more information please see IMF 2025 Article IV Report of Ethiopia, Box 2.

[32] Mauritania replaced the CIT holiday with a reduced rate in its new investment code adopted in 2025 and is planning to further rationalize CIT holidays contained in other preferential regimes.

reported in many LICs, including the extent of forgone rents, which further complicates cost–benefit assessment and raises governance challenges.

- **FDI Policies.** Although coverage for LICs in Global Trade Alert is limited, the available information suggests a shift toward more liberal FDI policy frameworks over the past decade. LICs have tended to introduce more liberalizing than restrictive measures, particularly in areas related to entry and ownership rules, investor treatment, and operational procedures (Figure 30). The number of restrictive measures appears to decline after 2009–13, while reforms aimed at easing entry or simplifying administrative requirements become more common. The relative predominance of regulatory reforms—compared with new financial incentives—may indicate a growing emphasis on improving the broader investment climate, possibly influenced by fiscal constraints as well as a recognition that procedural clarity and transparency can play an important role in supporting investor confidence.

Figure 30. LICs: Number of Announced FDI Policy Measures



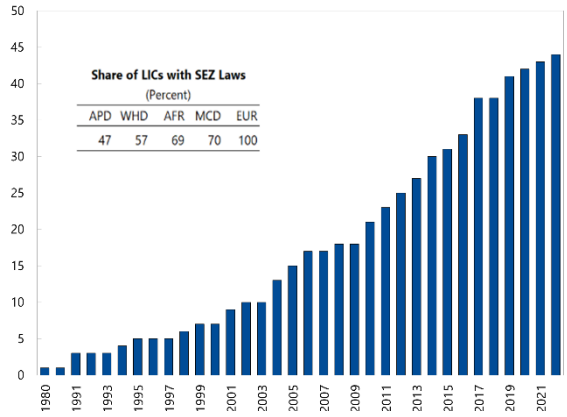
Sources: Global Trade Alert Database and IMF staff calculations.
Note: The total number of restrictive and liberalizing FDI policy measures between the indicated years for 18 LICs.

- **SEZs and investment promotion.** SEZs are a widely used instrument, with the number of LICs adopting SEZ laws rising sharply over the past two decades (Figure 31, left).[33] On a descriptive basis, LICs with SEZ laws receive only slightly higher FDI inflows relative to GDP than those without such legislation (Figure 31, right), suggesting that the presence of an SEZ framework alone is not sufficient to generate large or systematic increases in FDI. Descriptive relationships also do not identify causal effects or capture important differences in SEZ design, governance, and implementation capacity. These issues, together with the associated fiscal trade-offs and policy caveats, are discussed in Box 6.

[33] SEZs encompass a wide range of policy regimes and, in practice, often combine tax incentives with non-tax support such as subsidized land, infrastructure provision, or regulatory facilitation. In some LICs, SEZ-type regimes operate without a dedicated SEZ law—for example through export-processing zones or ad hoc tax-incentive schemes used in countries such as Liberia or Sierra Leone. While these arrangements can provide short-term benefits, the absence of a clear legal and governance framework often reduces transparency and limits the potential for broader spillovers.

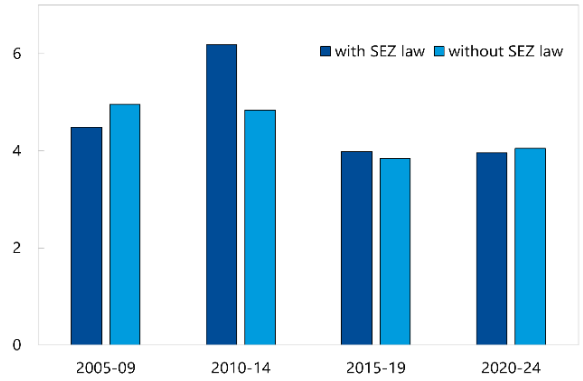
Figure 31. LICs: Special Economic Zone (SEZ) Law and FDI

The Number of LICs with SEZ Laws



FDI in LICs: With and Without SEZ Laws

(In percent of GDP)



Sources: Adrianople Group, Open Zone Map, IMF BoP Statistics, World Economic Outlook, and IMF staff calculations.

Box 6. Special Economic Zones (SEZs) in Developing Economies: Economic Gains, Fiscal Tradeoffs, and the Role of Tax Policy 1/

SEZs are widely used instruments to attract investment and support structural transformation. Their global footprint has expanded rapidly—from 79 zones in 1975 to more than 6,000 today, with over 5,000 mapped across 169 countries. Asia and the Pacific host about two-thirds of all SEZs, including large concentrations in China and the Philippines, while the United States, India, and Vietnam also host significant numbers. Zones vary widely in size, reflecting governments' belief that SEZs can accelerate industrialization, expand exports, and offer a more efficient operating environment.

Empirical evidence on the impact of SEZs on FDI is limited and highly heterogeneous across countries. Much of the positive evidence comes from a small number of well-documented success cases—most notably China, where SEZs have accounted for a large share of national FDI and are associated with higher FDI per capita without crowding out domestic investment. Additional successes are observed in a handful of middle-income economies, including Poland, Vietnam, Malaysia, Mauritius, Morocco, and the Dominican Republic, often concentrated in specific regions or sectors. Beyond these cases, however, the evidence is more mixed, with many studies finding weak or negligible effects. Establishing causality remains difficult even within countries, and a recurring concern is limited additionality—whether SEZs generate new investment or largely reallocate activity into the zone, with few spillovers to the broader economy.

Tax incentives, including CIT relief, do not appear to be the primary drivers of SEZ performance. While fiscal incentives may play a supporting role, the literature consistently highlights the importance of non-tax fundamentals—such as macroeconomic and political stability, credible legal and regulatory frameworks, governance quality, infrastructure provision, access to suitable labor, and proximity to markets. SEZs that combine effective governance with high-quality infrastructure and strong integration with local supply chains are more likely to attract FDI and generate localized spillovers. By contrast, zones that rely mainly on generous tax incentives, without addressing broader institutional and structural constraints, tend to underperform.

SEZs also entail significant fiscal risks. Many rely on generous profit-based incentives—such as CIT holidays, reduced rates, and exemptions on dividends or capital gains—that are costly, distortionary, and often ineffective, particularly when investment is relocated rather than additional. Revenue forgone can be substantial, while limited transparency hampers cost–benefit assessment. Evidence consistently shows that

Box 6. Special Economic Zones (SEZs) in Developing Economies: Economic Gains, Fiscal Tradeoffs, and the Role of Tax Policy (concluded)

tax incentives play a secondary role in investment decisions and will matter even less under the Global Minimum Tax, which curtails the effectiveness of profit-based incentives for large multinationals.

A sound SEZ tax framework should emphasize neutrality, simplicity, and transparency. Incentives should be selective, time-bound, and aligned with clear policy objectives, complementing—rather than substituting for—strong non-fiscal fundamentals. Cost-based incentives, such as accelerated depreciation, investment allowances, or training-related deductions, are generally more efficient and less distortionary than profit-based exemptions. Maintaining a minimum effective tax rate of 15 percent for large multinationals is increasingly important under GMT rules.

Strong oversight and accountability are essential to ensure that SEZs do not lead to inefficient resource allocation. Where governance and administrative capacity are weak, SEZs risk diverting capital and labor toward protected or lower-productivity activities, crowding out investment elsewhere in the economy, and reinforcing enclave development with limited spillovers to employment, productivity, or domestic value chains. As emphasized in recent IMF guidance on industrial policy and the October 2025 World Economic Outlook, SEZ frameworks place substantial demands on transparency, coordination, and enforcement; absent these conditions, zones may become fiscal liabilities rather than catalysts for development. This underscores the importance of cautious SEZ design, clear eligibility criteria, sunset clauses, regular evaluation, and close integration with broader institutional and fiscal reforms.

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1/ This box is based on the forthcoming IMF How-To Note, "Special Economic Zones: What are They, and How Governments Should Tax Them?" (Washington DC: International Monetary Fund).

53. Core fiscal institutions—particularly revenue administration and PFM—are also likely to play an important role in shaping the credibility and predictability of the fiscal environment faced by foreign investors. Even when statutory tax rates or incentive regimes appear competitive, investors often assess whether fiscal institutions support consistent policy implementation, efficient public service delivery, and reliable enforcement.

- **Revenue administration.** Competitive statutory tax rates may have limited effect if tax administration practices introduce uncertainty or high compliance costs. Lengthy filing procedures, inconsistent enforcement, or weak dispute-resolution mechanisms can reduce predictability—an aspect foreign investors often view as important when assessing investment locations. Customs administration is a closely related dimension of revenue administration and is particularly important for trade-intensive investment, as inefficient or unpredictable border procedures can raise input costs, create delays, and undermine the reliability of import-export operations. Empirical work suggests that complex or nontransparent tax systems are associated with lower FDI inflows, particularly in developing economies (Djankov et al., 2010; IMF 2018). By contrast, streamlined and digitalized processes—such as e-filing, electronic payment platforms, and risk-based audit systems—tend to lower compliance burdens and improve transparency, as illustrated in Liberia and the Maldives (Section E). Establishing large taxpayer offices, strengthening taxpayer services, and ensuring fair and timely appeals procedures can further support administrative certainty and help mitigate corruption risks, which several studies identify as relevant considerations for investment decisions (Faccio, 2006; Keen, Mansour & Prichard, 2017).

- **Public financial management.** Effective PFM systems can enhance fiscal credibility and support a more favorable investment environment by helping ensure that public resources are allocated, executed, and reported in a transparent manner. Strong public investment management (PIM) frameworks—covering project appraisal, selection, budgeting, procurement, and execution—are often associated with higher-quality and more reliable infrastructure, a factor commonly cited in FDI location decisions. Empirical studies suggest that well-governed public investment systems may help crowd in private and foreign investment by reducing project uncertainty, lowering transaction costs, and improving complementary services (IMF 2015; Dabla-Norris et al., 2012; Calderón & Servén, 2010). Likewise, credible budget execution, timely payments to contractors, and robust internal controls can reduce the risk of arrears, cost overruns, and procurement disputes—issues that investors sometimes interpret as signals of fiscal discipline and operational predictability. Conversely, weak PFM systems—characterized by fragmented capital budgeting, limited project appraisal capacity, or opaque procurement processes—may heighten macro-fiscal risks and dampen investor confidence. Cross-country evidence indicates that countries with stronger PIM and Public Expenditure and Financial Accountability (PEFA) scores tend to achieve higher returns on public capital, more efficient infrastructure delivery, and greater complementarities with private investment, underscoring the potential role of sound fiscal institutions in supporting long-term FDI (Ang et al., 2010; Warner, 2014; Rajaram et al., 2014; Gollwitzer, 2011).

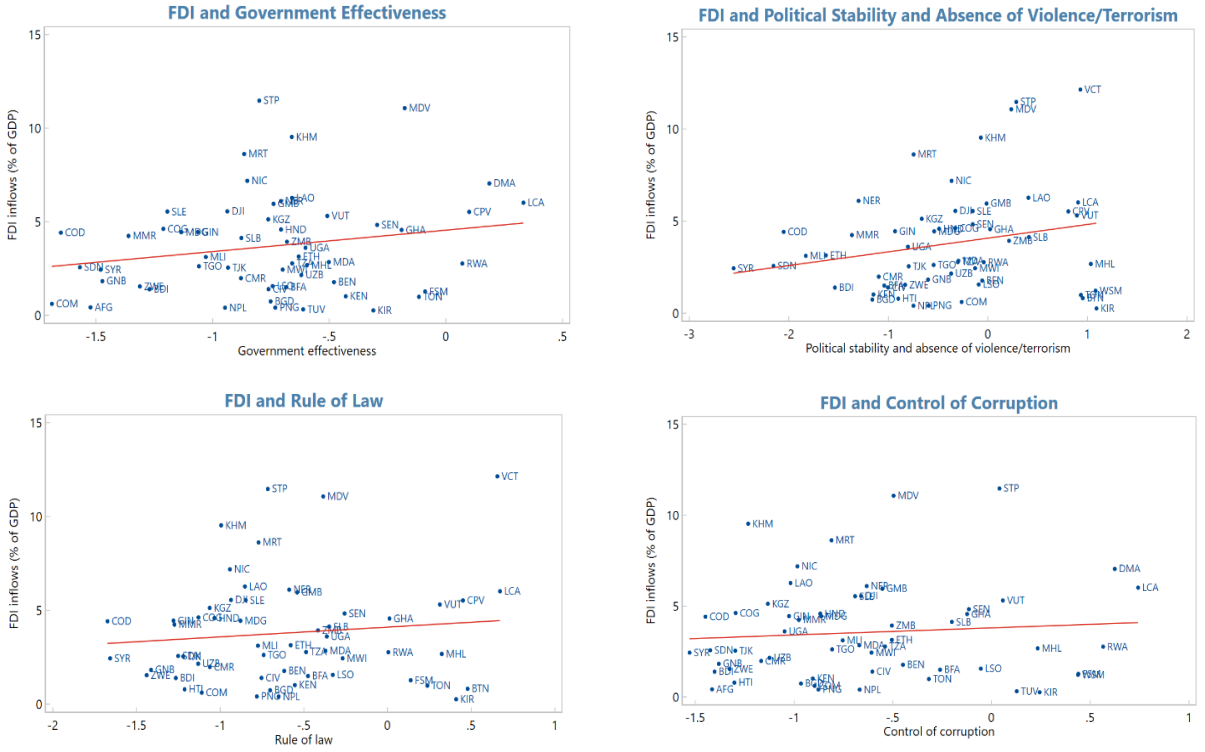
54. Beyond fiscal institutions, the broader institutional and business environment would also be relevant for feasibility, profitability, and risk profile of foreign investment projects. These structural conditions influence how policies are implemented in practice and how predictable the operating environment is for investors, and in many cases matter as much as—or more than—fiscal incentives in determining FDI outcomes.

- **Business climate.** The broader business environment—institutional, policy, regulatory, and infrastructure environment—can play an important role in shaping the feasibility and profitability of investment projects, and in many cases may matter as much as, or more than, tax incentives. Reliable infrastructure—particularly electricity, transport, and logistics—is frequently cited as a key consideration in FDI location decisions (UNCTAD 2022; Escribano, Guasch, & de Orte 2010). In many LICs, however, challenges such as intermittent power supply, high electricity costs, and limited transport connectivity raise production costs and can constrain competitiveness, particularly for export-oriented and manufacturing activities (IMF 2023a; Calderón & Servén 2010; World Bank 2020; ADB 2023). Weak property-rights systems, insecure land tenure, and slow or unpredictable commercial court processes may also increase investor risk and make long-term commitments less attractive (North 1990; World Bank 2021). In this context, addressing these structural constraints can, in some settings, prove more effective for attracting FDI than expanding tax incentives.

- **Governance and institutional quality.** Governance underpins both fiscal performance and business-climate reforms and is a key determinant of FDI outcomes. As emphasized in the 2018 Framework on Enhanced Engagement in Governance (IMF 2018b), weaknesses in governance—

including corruption—can undermine institutional development and macro-fiscal credibility by eroding revenue mobilization, distorting public spending priorities, and weakening transparency and accountability. Such weaknesses are often associated with political instability and policy uncertainty, increase the scope for discretion and rent-seeking, and reduce the effectiveness of investment-related reforms, thereby discouraging higher-quality and longer-term FDI (Busse and Hefeker 2007). An important and closely related dimension is the availability, reliability, and timeliness of economic and fiscal data, which shape investors' ability to assess risks, returns, and policy credibility. Empirical evidence suggests that LICs with stronger regulatory quality, better control of corruption, and more predictable policymaking often receive higher and more stable FDI inflows, including outside resource-intensive sectors (Mihalyi & Morris 2021). This broad relationship is illustrated in Figure 32, which shows generally positive correlations between governance indicators and FDI performance across LICs[34].

Figure 32. LICs: FDI and Governance Indicators



Sources: IMF BoP Statistics and WB World Governance Indicators.
Note: Average for 2010-24. WGI Scores range from -2.5 (weak) to 2.5 (strong).

[34] All four governance indicators are positively associated with FDI performance; in the four bivariate scatter plots, the estimated slope coefficients are positive, and those for government effectiveness and political stability and absence of violence/terrorism are statistically significant.

D. Empirical Assessment of Key Domestic Pull Factors Shaping FDI into LICs

55. To assess the structural and fiscal pull factors shaping FDI inflows into LICs, the analysis combines two complementary empirical approaches: a bilateral gravity-model framework and event-study–type local projection (LP) estimates. This dual strategy is motivated by data limitations in LICs and by the need to distinguish between long-run cross-country correlates of FDI and the dynamic effects of discrete policy reforms. The gravity model provides a cross-sectional and panel perspective on how fiscal discipline, fiscal institutions, and broader institutional settings are associated with the allocation of FDI across countries, while the LP approach examines how identifiable changes in fiscal incentives—such as the adoption of SEZ legislation or reductions in the tax burden—affect FDI dynamics within countries over time.

- **Gravity model.** The gravity framework offers a structured way to analyze bilateral FDI flows using the World Bank's Harmonized Bilateral FDI (HBFDI) database and complementary firm-level data from ORBIS Cross-border Investment Database (Orbis). Consistent with standard gravity formulations, bilateral FDI inflows are modeled as a function of host-country fundamentals alongside source-country characteristics and bilateral frictions such as geographic distance and common language. The preferred Poisson pseudo-maximum likelihood (PPML) estimator accommodates the prevalence of zero FDI flows and heteroskedasticity common in LIC data. Specifications include year fixed effects to absorb global shocks and, depending on the question, host- and source-country fixed effects or higher-dimensional fixed effects to control for time-invariant country characteristics and stable bilateral relationships. Fiscal discipline, fiscal institutions, and broader institutional variables—including the public debt-to-GDP ratio and a rich set of qualitative variables (Table 2) are introduced sequentially to assess their marginal contribution while limiting multicollinearity.

- **Local projections.** In parallel, the LP framework examines how discrete policy reforms—such as the adoption of SEZ legislation or episodes of tax burden reduction—affect the trajectory of FDI inflows over subsequent years. This event-study design traces both the immediate signaling effect and the medium-term credibility gains associated with reforms. It also allows the analysis to test whether FDI responses vary with institutional strength, shedding light on the conditions under which reforms successfully attract sustained and higher-quality foreign investment.

Table 2. Key Qualitative Variables Used in The Gravity Analysis

Bucket	Variable	Description
Fiscal discipline	CPIA: fiscal policy	Assesses the sustainability of fiscal policy over the short and medium term, including consistency with macroeconomic stability and public debt sustainability.
	CPIA: debt policy and management	Evaluates whether debt management practices limit fiscal risks and support medium- to long-term debt sustainability.

Table 2. Key Qualitative Variables Used in The Gravity Analysis (concluded)

Fiscal institutions	CPIA: quality of budgetary and financial management	Measures the credibility of the budget, effectiveness of financial management systems, and timeliness and reliability of fiscal reporting.
	CPIA: efficiency of revenue mobilization	Assesses the effectiveness and predictability of revenue mobilization, reflecting both tax policy and administration.
	ISORA: digitalization	Captures the use of digital technologies in tax administration, including e-filing, e-payments, and e-services.
	ISORA: operational strength index	Composite measure of the strength of revenue administration practices and institutional capacity, based on ISORA indicators.
Fiscal institutions	CPIA: transparency and accountability	Evaluates fiscal transparency, public access to budget information, and accountability and oversight mechanisms.
	OBI: fiscal transparency	Independent measure of fiscal transparency based on the availability, timeliness, and comprehensiveness of published budget documents.
Broader institution settings	Governance	Authors' calculations, based on a principal component analysis (PCA) of the six WGI pillars (voice, stability, effectiveness, regulation, rule of law, corruption control).
	WGI: rule of law	Measures confidence in and adherence to laws, including contract enforcement, property rights, and the effectiveness of courts.
	Chinn-Ito capital account openness index	De jure measure of capital account openness based on IMF AREAER restrictions.

Note: CPIA refers to the Country Policy and Institutional Assessment of the World Bank; ISORA refers to the International Survey on Revenue Administration coordinated by the IMF, OECD, IADB, and CIAT; and OBI refers to the Open Budget Index, produced by the International Budget Partnership, which measures fiscal transparency based on publicly available budget information.

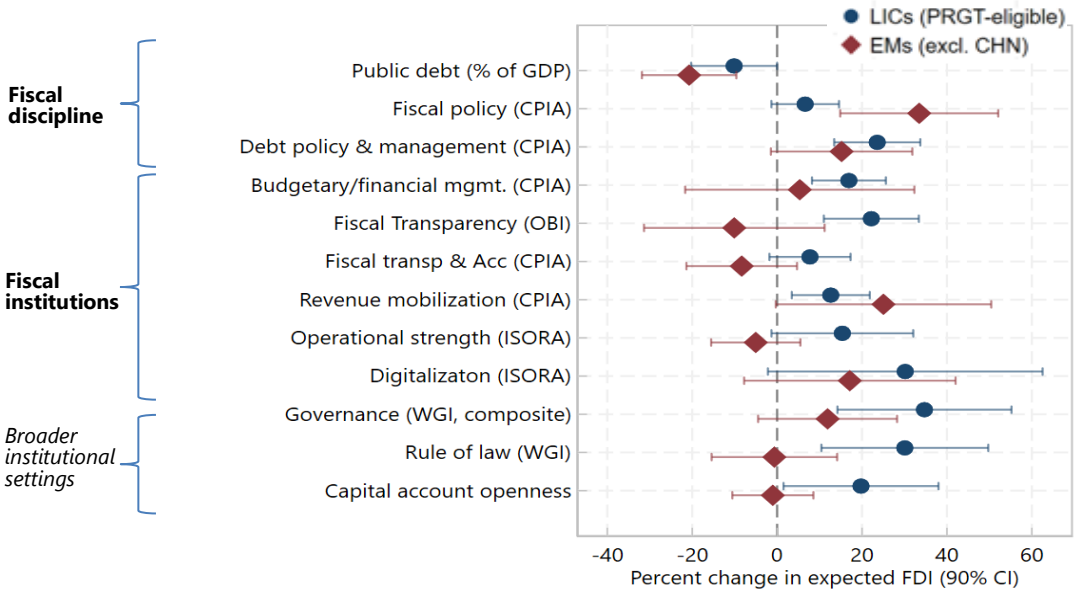
56. The gravity-model results indicate a strong association between fiscal discipline, fiscal and broader institutional quality, and FDI inflows to LICs, with these relationships generally more pronounced than in EMs (Figure 33).[35] To facilitate comparability across income groups, marginal effects are reported for variables normalized using a common standard deviation computed over the pooled LIC–EM sample. Beyond standard gravity determinants, the results for LICs (blue markers) indicate that LICs with stronger fiscal discipline—proxied by lower public debt and higher CPIA ratings for fiscal and debt policy—tend to receive higher FDI inflows. Similarly, higher-quality fiscal institutions, reflected in CPIA indicators for public financial management and efficiency of revenue mobilization as well as the quality of revenue administration proxied by ISORA are associated with significantly larger FDI inflows. Additionally, broader institutional settings, such as governance, rule of law, property right, and capital account openness are also positively correlated with FDI inflows to LICs.[36] By comparison, the corresponding estimates for EMs (red markers) are generally smaller in magnitude and less precisely estimated, indicating that while fiscal and institutional factors matter across country groups, their association with FDI outcomes appears

[35] Additional gravity specifications including natural resource rents (percent of GDP) were estimated. However, because resource endowments are largely time invariant, their effects are substantially absorbed by host-country fixed effects, making them difficult to identify separately in a within-country framework. Consistent with this, controlling for resource rents does not materially alter the estimated marginal effects of fiscal discipline, fiscal institutions, or broader institutional settings for LICs.

[36] These findings are consistent with earlier IMF analysis showing that stronger fiscal positions and credible fiscal frameworks reduce perceived sovereign risk and support private capital inflows, including FDI, in emerging market and developing economies (IMF, Fiscal Monitor, April 2016). The results are also robust to alternative specifications that incorporate high-dimensional fixed effects, including source-country–year and host–source (pair) fixed effects, which absorb time-varying global push factors and time-invariant bilateral characteristics (see Annex VI).

stronger in LICs. This contrast may partly reflect differences in FDI composition: in EMs, a larger share of FDI takes the form of cross-border M&A, which are driven more by asset valuations and ownership considerations than by host-country fiscal policy or institutions. Results for EMs should also be interpreted with some caution, given more limited coverage of CPIA-related indicators relative to LICs. These relationships are robust across alternative specifications, including models with high-dimensional fixed effects that absorb source-year and bilateral factors and trade openness (see Annex VI for further details).

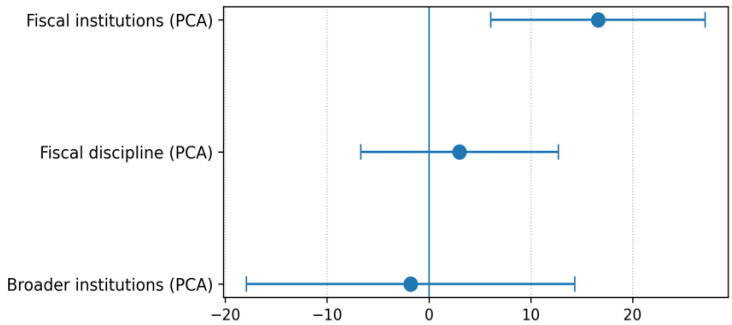
Figure 33. LICs and EMs: Gravity Model Estimates of Fiscal Drivers of FDI



Notes: Estimates show percent changes in expected FDI (US$) for a one–standard-deviation increase in each variable (standardized over the pooled LIC–EM sample). 90 percent confidence intervals are shown.

57. Fiscal institutions emerge as a more important correlate of FDI inflows to LICs than fiscal discipline or broader institutional quality. To assess the relative importance of institutional channels while addressing multicollinearity, the analysis constructs principal components for fiscal discipline, fiscal institutions, and broader institutional settings and includes them jointly in the gravity model. As shown in Figure 34, the principal component capturing fiscal institutions is positive and

Figure 34. LICs: Relative Importance of Fiscal Discipline, Fiscal Institutions, and Broader Institutions

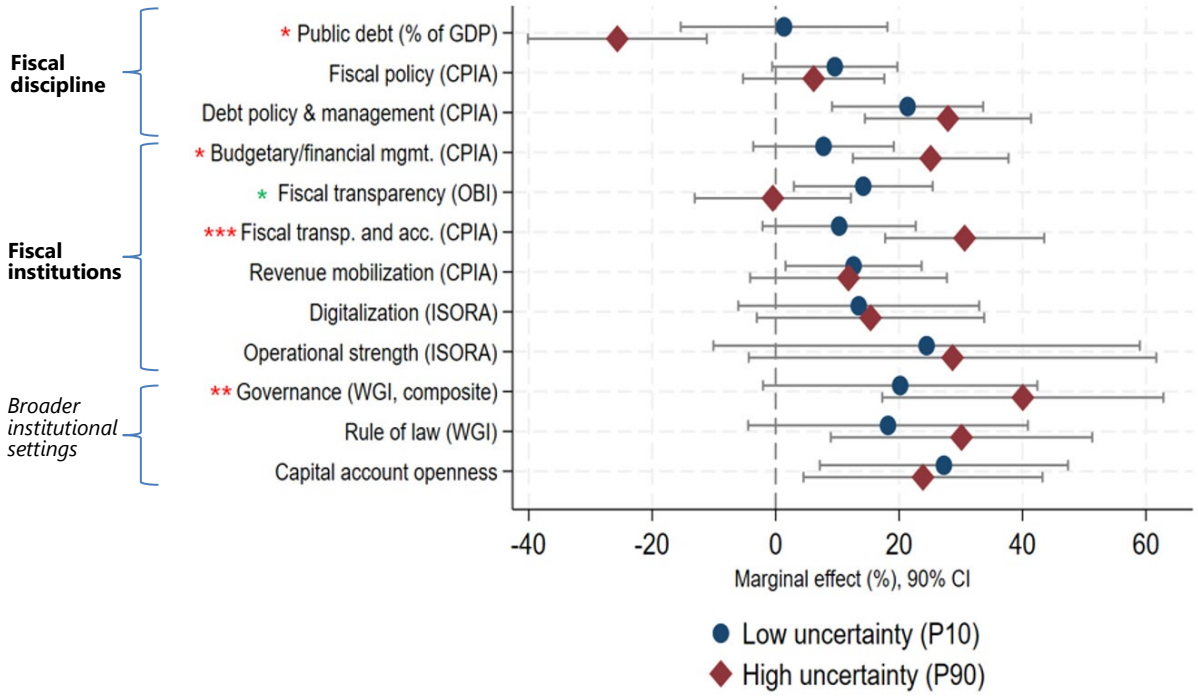


Notes: The figure reports gravity estimates using principal component analysis (PCA) for three institutional buckets—fiscal discipline, fiscal institutions, and broader institutional quality—each constructed from the indicators introduced individually in the preceding analysis. For fiscal institutions, the PCA excludes ISORA indicators, which have limited time coverage, to ensure sufficiently long and coherent time series.

statistically significant, while the contribution of fiscal discipline becomes smaller and less precisely estimated once fiscal institutions are controlled for, and broader institutional quality is not statistically distinguishable from zero (see Annex IV for additional horse-race results, including pairwise comparisons). These results indicate that, conditional on macro-fiscal discipline and broader governance conditions, fiscal institutions are more strongly associated with FDI inflows in LICs.

58. Fiscal discipline and institutional quality matter more for FDI outcomes when uncertainty is elevated. Gravity estimates show larger marginal effects of fiscal discipline, fiscal institutions, and broader institutional quality under high uncertainty than under low uncertainty (Figure 35). In particular, stronger debt management, budgetary and financial management, and revenue administration are associated with higher FDI responses, while elevated public debt is more negatively associated with FDI when uncertainty is high. Similar patterns hold for broader institutional quality, including governance and the rule of law, underscoring the relatively greater importance of fiscal credibility and institutional strength in high-uncertainty settings

Figure 35. LICs: Gravity Model Estimates of Fiscal Drivers of FDI by Uncertainty

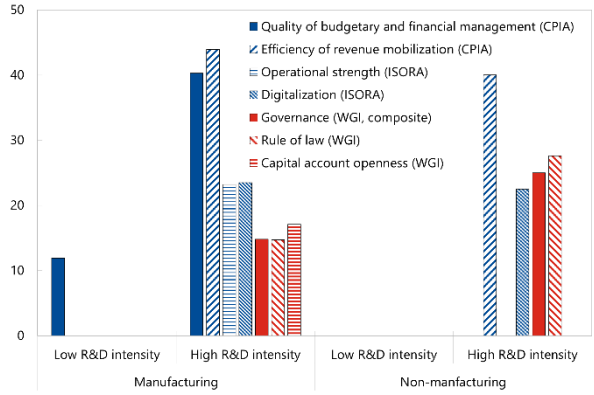


Notes: The figure reports marginal effects from gravity regressions that interact each fiscal or institutional variable with country-specific uncertainty (measured by the World Uncertainty Index, WUI). Effects show the impact of a one–standard-deviation increase in each variable on expected FDI (US$), evaluated at low uncertainty (10th percentile of the standardized WUI) and high uncertainty (90th percentile). Regressions include baseline gravity controls and fixed effects. Bars denote 90 percent confidence intervals (see Annex VI for more details). Differences between high- and low-uncertainty marginal effects are formally tested; red symbols (*, **, ***) indicate statistically significant differences at the 90 percent confidence level. The Open Budget Index (OBI)–based fiscal transparency measure also shows a statistically significant difference, but with the opposite sign.

59. Building on the gravity analysis and using project-level greenfield FDI data from Orbis, sector-level evidence for EMDEs is consistent with stronger fiscal and other institutionals being associated with more R&D-intensive FDI (Figure 36). Merging the baseline gravity-model dataset with Orbis data disaggregated by sector and R&D intensity reveals a clear pattern of institutional selectivity: stronger fiscal institutions—particularly the quality of budgetary and financial management and the efficiency of revenue mobilization—tend to be more strongly correlated with high-R&D manufacturing FDI than with low-R&D projects, including mining. A similar gradient emerges for broader institutional indicators, including rule of law and overall governance quality, which are weakly associated with low-R&D manufacturing and non-manufacturing activities but more strongly correlated with high-R&D manufacturing and non-manufacturing investment. Capital account openness, by contrast, appears to be more closely associated with high-R&D manufacturing FDI, with limited evidence of a comparable relationship for high-R&D non-manufacturing activities. Overall, the results suggest that credible fiscal and governance frameworks are particularly relevant for technologically sophisticated, knowledge-intensive FDI rather than FDI in activities that are labor-intensive with limited technological content or those in highly capital-intensive extractive investments, generally consistent with existing studies showing that higher-value forms of FDI are more responsive to institutional quality, contract enforcement, and policy stability (Javorcik 2004; Alfaro and Charlton 2009; Keller 2010; Harrison and Rodríguez-Clare 2010).

Figure 36. EMDEs. Effect of Institutions on Quality of FDI

(In percent)



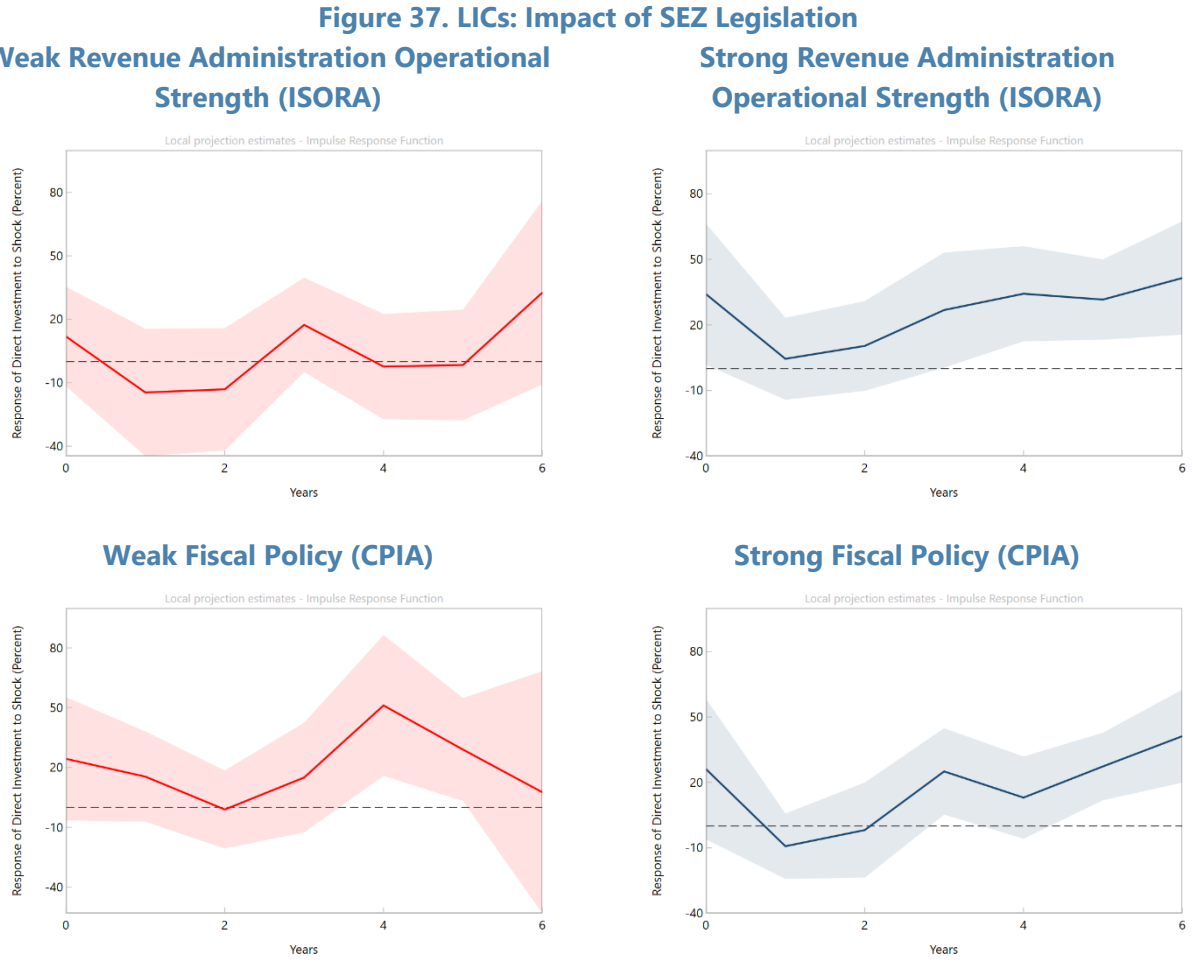
Note: Bars show coefficients that are statistically significant at the 10 percent level; missing bars indicate estimates not statistically different from zero. Regressions are estimated for EMDEs, as the LIC sample is too sparse for sector-level analysis. Host- and source-country fixed effects are excluded due to limited within-country variation at the sectoral level.

60. The LP estimates indicate that SEZ legislation and tax reduction episodes are associated with higher FDI mainly in LICs with stronger fiscal discipline and institutional frameworks, while LICs with weaker capacity show little or no discernible response.

- **SEZ legislation.** LICs with stronger fiscal discipline—as measured by the CPIA fiscal policy rating—experience a larger and more persistent increase in FDI following SEZ approval, while countries with weaker ratings display little or no durable response (Figure 37 bottoms). A similar but complementary pattern emerges for fiscal institutional capacity: LICs with stronger revenue administration operational strength, as captured by ISORA, exhibit a more pronounced and

sustained FDI response than those with weaker administrative capacity (Figure 37, tops).[37] The effects emerge with a lag, reflecting the time between legislative approval and project implementation. Results should be interpreted with caution, as the analysis focuses on FDI inflows rather than overall investment, and SEZ outcomes vary widely with zone design, governance, and integration into the domestic economy, with performance shaped more by the broader institutional environment than by tax incentives alone.

Figure 37. LICs: Impact of SEZ Legislation

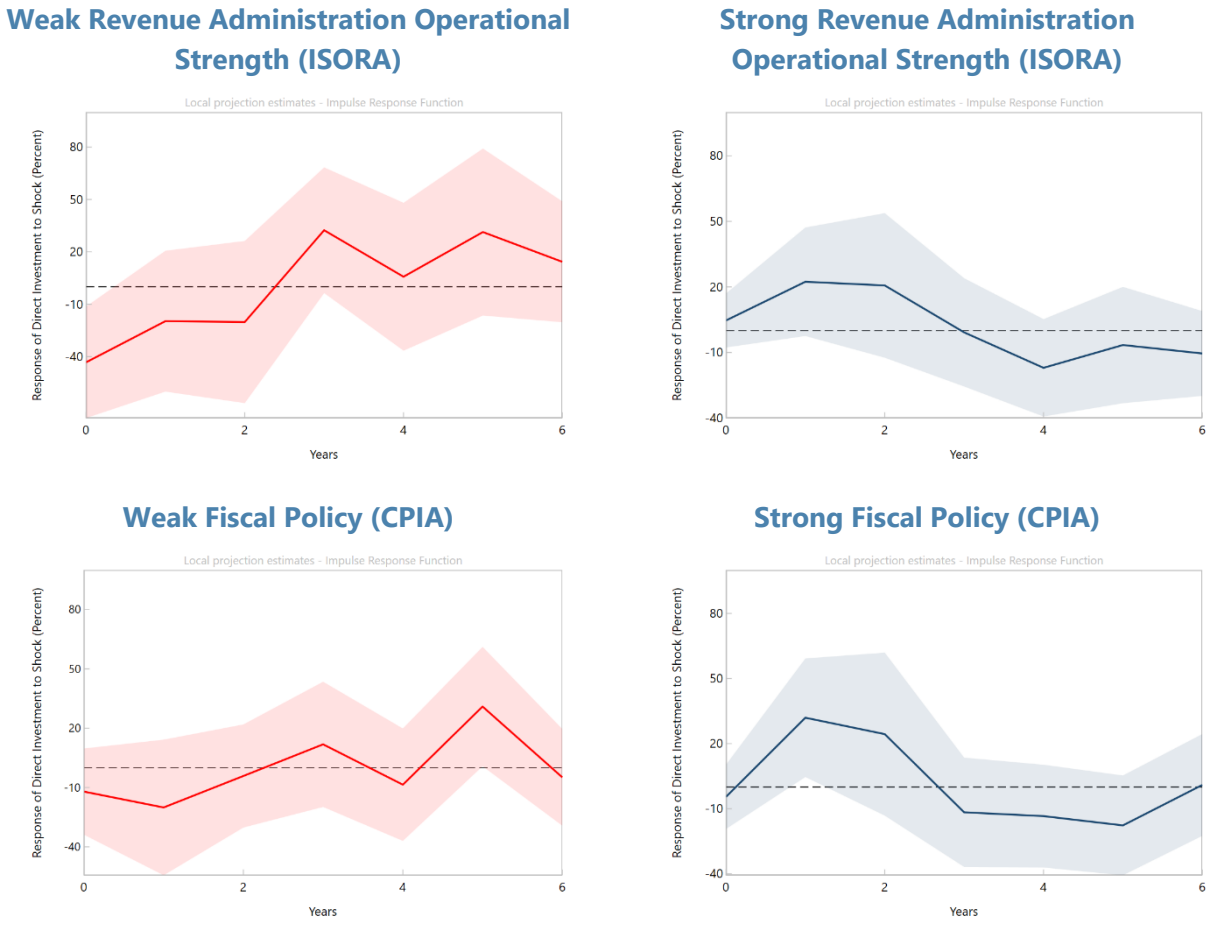


Note: These charts show impulse response functions estimated using Jordà local projections to assess the heterogeneous impact of selected fiscal reforms on direct investment for countries with above- and below-median CPIA fiscal policy ratings. Lines indicate point estimates and shaded areas denote 90 percent confidence intervals. Year 0 is the year of the shock. See Annex VI for further details.

[37] For both the CPIA- and ISORA-based heterogeneity analysis, institutional strength categories are defined using each country's average institutional score over the full sample period and therefore remain fixed over time, ensuring that groupings are not mechanically affected by year-to-year movements in global uncertainty. The baseline local-projection specification includes year fixed effects to absorb common global shocks, and results are robust to additionally controlling for country-level uncertainty (World Uncertainty Index) (see Annex VI).

- **Tax reduction episodes.**[38] Tax reductions generate at most a short-lived increase in FDI, and only in LICs with stronger fiscal discipline as measured by the CPIA fiscal policy rating (Figure 38). Countries with weaker fiscal discipline show no meaningful response, while splits based on ISORA revenue administration capacity yield qualitatively similar but statistically insignificant effects. Overall, the results suggest that tax cuts alone are unlikely to deliver sustained FDI gains in the absence of credible fiscal policy frameworks and supporting institutions.

Figure 38. LICs: Impulse Responses to Fiscal Reform Shocks



Sources: WEO, WDI, and IMF staff calculations.
Note: These charts show impulse response functions estimated using Jordà local projections to assess the heterogeneous impact of selected fiscal reforms on direct investment for countries with above- and below-median CPIA fiscal policy ratings. Lines indicate point estimates and shaded areas denote 90 percent confidence intervals. Year 0 is the year of the shock. See Annex VI for further details.

[38] Tax-burden-reduction episodes are identified using the Global Tax Policy and Revenue Evaluation Database (TAPRED), which compiles reform-driven tax reduction episodes referenced in IMF Country Reports using AI-based methods. The resulting indicator is a binary variable that identifies whether a country implemented a tax reform that was expected, at the time of approval, to reduce overall tax collection.

E. Lessons from Country Reform Experiences

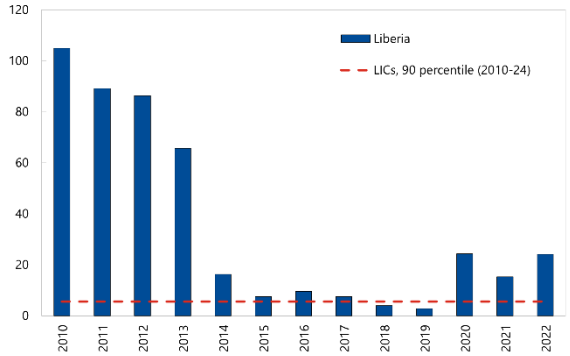
61. The four cases reviewed below examine how reforms to revenue administration and PFM have evolved across different institutional settings, and how these reforms have coincided with shifts in FDI inflows in these countries. These experiences also underscore important limitations. Reform outcomes have often been constrained by uneven implementation capacity, gaps in enforcement and transparency, and continued reliance on discretionary tax incentives, including ad-hoc, project-specific exemptions that have contributed to tax base erosion and weakened policy credibility. In addition, FDI has frequently remained concentrated in a narrow set of enclave sectors, with limited spillovers to employment, productivity, and domestic value chains. The country cases are therefore presented as descriptive illustrations of how revenue administration and PFM reforms interact with FDI outcomes in practice, providing context for the analytical assessment that follows in subsequent sections.

Revenue Administration Reforms

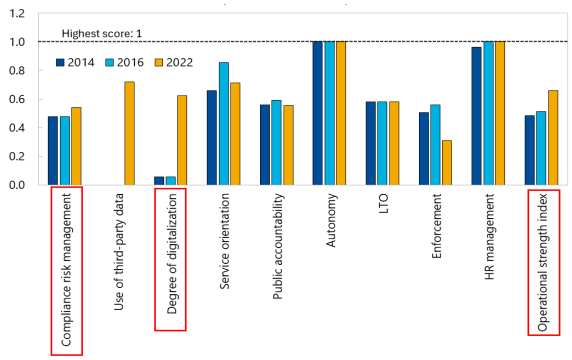
62. Following the attainment of the HIPC Completion Point in mid-2010, Liberia implemented legal, institutional, and administrative reforms that improved policy predictability for foreign investors. Reforms anchored in the Liberia Revenue Code and the Investment Act (2010) simplified business registration and established core investor protections—including non-discrimination, safeguards against expropriation, and the right to repatriate profits—helping anchor investor confidence. In parallel, tax and customs administration were modernized through the rollout of the Liberia Integrated Tax Administration System and the use of ASYCUDA in customs, expanding electronic filing and payment, improving transparency and service quality, and reducing compliance costs. These reforms, complemented by targeted sectoral tax incentives and broader infrastructure and governance improvements, coincided with a sharp rise in FDI, making Liberia one of the highest FDI recipients among LICs relative to GDP, although inflows remained concentrated in extractive sectors and proved difficult to sustain over time. Further strengthening implementation, enforcement, and transparency—through fuller automation, risk-based customs controls, improved system integration, and a more rules-based approach to tax incentives, more effective dispute-resolution mechanisms, and a clean and up-to-date taxpayer register—would help broaden FDI beyond enclave sectors, with IMF technical assistance continuing to support the authorities' reform agenda.

Figure 39. Liberia: FDI and ISORA Score

Liberia: FDI Inflows
(Percent of GDP)



Liberia: ISORA Score
(Scale from 0 to 1)

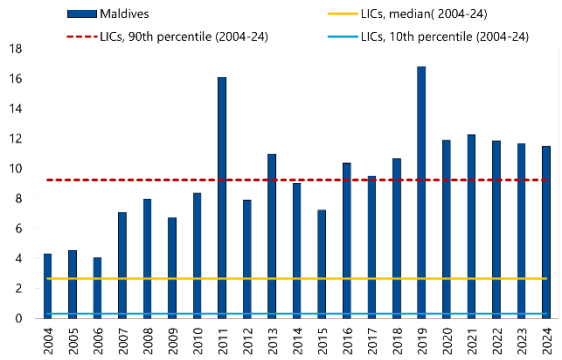


Sources: IMF BoP Statistics, ISORA, and WB World Governance Indicators.

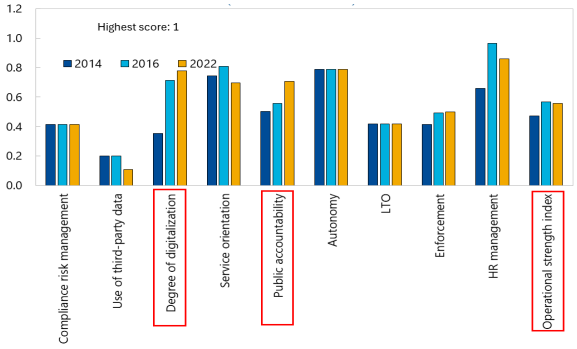
63. The Maldives illustrates how relatively strong institutional capacity and effective, increasingly digitalized revenue administration can complement a tourism-led investment model. Since the early 2010s, FDI inflows—mainly in tourism and hospitality—have averaged about 12 percent of GDP over the past five years, exceeding the LIC median. While natural endowments and high returns remain the primary drivers, predictable administration supported by strong institutional autonomy, clear legal mandates, and rapid digitalization has helped sustain investor confidence. Online filing and payment increased from about 45 and 40 percent in 2018 to nearly 90 and 85 percent in 2022, respectively, reducing compliance costs, accelerating VAT refunds, and strengthening dispute-resolution mechanisms. At the same time, heavy sectoral concentration and reliance on a narrow taxpayer base highlight the need for diversification to enhance fiscal resilience and reduce exposure to sector-specific shocks.

Figure 40. The Maldives: FDI and ISORA Score

Maldives: FDI Inflows
(Percent of GDP)



Maldives: ISORA Score
(Scale from 0 to 1)

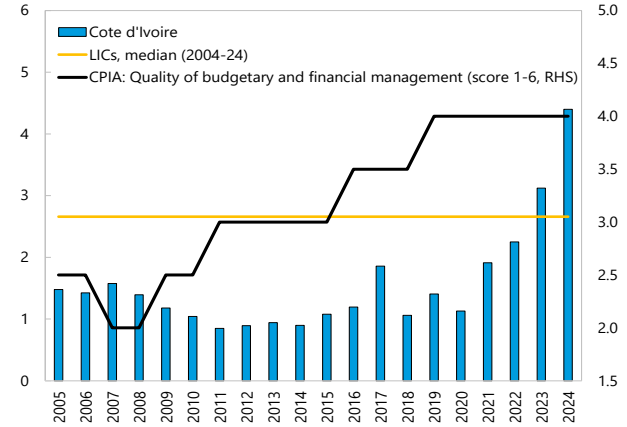


Sources: IMF BoP Statistics, ISORA, and WB World Governance Indicators.

Public Financial Management Reforms (PFM)

64. Côte d'Ivoire's experience illustrates how a sequenced and institutionalized PFM and public investment management reform agenda can coincide with rising FDI inflows in a context of strengthening macro-fiscal credibility. Since 2017, the authorities have implemented a coherent reform strategy covering program budgeting, public investment management (PIM), treasury single account and cash-management reforms, and the gradual integration of climate considerations into fiscal frameworks. Early diagnostics, including the 2017 Public Investment Management Assessment and its 2021 follow-up, identified weaknesses in project appraisal, selection, and fiscal risk management, which informed subsequent legal and institutional reforms. These efforts culminated in the adoption of Decree No. 2022-742 of September 28, 2022, which established a comprehensive legal framework for PIM. Building on this foundation, subsequent reforms supported by the IMF have increasingly integrated climate considerations into PFM and PIM, including the introduction of climate tagging of public investment expenditures and strengthened fiscal risk statements incorporating quantitative disaster risk analysis. These reforms were reinforced through IMF technical assistance and Fund-supported programs, including fiscal consolidation toward the WAEMU deficit ceiling under the 2023 ECF/EFF arrangement, as well as climate-related measures supported under the RSF. Over this period, FDI inflows increased markedly—from just over US$1 billion in 2021 to a record US$3.8 billion (about 4.4 percent of GDP) in 2024—alongside enhanced fiscal transparency and climate-aligned PFM measures supported under the RSF. While no causal inference is implied, the timing and coherence of reforms are consistent with improved investor confidence. At the same time, continued geographic and sectoral concentration of FDI underscores the need to sustain reforms, strengthen domestic linkages, and promote diversification to translate higher investment into broader productivity and growth gains.

Figure 41. Côte d'Ivoire: FDI and PFM Scores
(Percent of GDP, unless otherwise indicated)

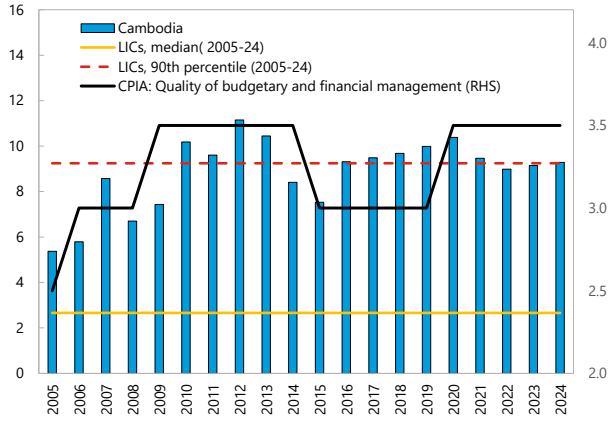


Sources: IMF BoP Statistics, World Economic Outlook, WB CPIA, WB World Governance Indicators, and IMF staff calculations.

65. Cambodia's experience illustrates how strengthening PFM frameworks can support a more predictable macro-fiscal environment for FDI. Over the past two decades, FDI has remained an important feature of the economy, reflecting deep regional integration—particularly with China, Japan, and Singapore—and gradual diversification beyond low-tech manufacturing, while persistent structural constraints underscore the importance of sound fiscal institutions. Recent reforms have focused on reinforcing the legal and institutional foundations of fiscal management, notably through the 2023 Public Financial System Law, which modernizes budget preparation and execution, formalizes program budgeting and medium-term fiscal frameworks, strengthens transparency and National Assembly oversight, and establishes a fiscal reserve fund for crisis

response. In parallel, reforms have also targeted the PFM digital ecosystem, including the development of an FMIS strategy and system review, strengthened budget execution and commitment controls, and the implementation of an arrears clearance roadmap. Continued progress on the IPSAS transition, supported by IMF capacity development, has further improved the quality, consistency, and timeliness of fiscal reporting. Taken together, these reforms have strengthened fiscal reporting and execution predictability—credibility-related channels relevant for investor planning and risk assessment.

Figure 42. Cambodia: FDI and PFM Scores
(Percent of GDP, unless otherwise indicated)



Sources: IMF BoP Statistics, World Economic Outlook, WB CPIA, WB World Governance Indicators, and IMF staff calculations.

F. Policy Implications and Recommendations

66. The analysis suggests that FDI in LICs is significantly influenced by the quality of fiscal policy management, and the strength of fiscal and other institutions, and to a notably lesser extent by fiscal incentives (including SEZs). Gravity-model results show that fiscal discipline and fiscal institutions—particularly in revenue administration and public financial management—are positively associated with FDI inflows, with effects that are stronger in LICs than in EMs, amplified in high-uncertainty settings, and linked to more R&D-intensive investment; when considered jointly with broader institutional quality, fiscal institutions emerge as more important institutional correlate of FDI. Complementary evidence from the LP analysis suggests that fiscal incentives are associated with higher FDI only where fiscal discipline and fiscal institutions are strong, and yield limited gains otherwise. In the current global context—marked by heightened geopolitical tensions, trade fragmentation, and more selective capital flows—these findings take on greater urgency. LICs with credible fiscal frameworks and strong institutions are better positioned to attract sustained and higher-quality FDI, while those with weaker fundamentals risk being bypassed. These results inform the policy recommendations that follow, which emphasize strengthening macro-fiscal credibility and fiscal institutions, exercising caution in the use of fiscal incentives, and sequencing reforms in line with country capacity.

Fiscal Discipline

67. Consistent with the gravity results, strengthening fiscal credibility—within a broader commitment to sound macroeconomic policy management and debt sustainability—remains the top priority. Beyond the level of the fiscal stance itself, investors look for signals that fiscal policy is predictable, transparent, and guided by clearly articulated plans. Fiscal credibility is shaped by the government's record of adhering to announced budget targets, the quality and timeliness of

fiscal data, and the extent to which policy decisions follow established procedures rather than ad hoc adjustments. Measures that can reinforce credibility include publishing medium-term fiscal frameworks grounded in realistic assumptions, improving the transparency of budget execution, and strengthening internal controls to limit off-budget operations. Enhanced disclosure of SOE liabilities and other contingent risks can also help clarify the government's fiscal position and reduce uncertainty. Well-designed fiscal rules may provide an additional anchor when they are tailored to country capacity, paired with transparent monitoring arrangements, and supported by credible institutions. Together, these steps help signal a more predictable fiscal policy environment, which can reduce the likelihood of abrupt policy shifts and support investor confidence.

68. The design of fiscal incentives should aim to create a predictable and cost-effective investment environment, rather than to provide excessive profit-based incentives for FDI. Evidence indicates that profit-based incentives often have limited additionality and can erode revenues, exacerbating fiscal pressures in the medium to long run. Importantly, incentives that appear effective in attracting FDI are not necessarily welfare-enhancing, as benefits may be small relative to their fiscal cost and depend on design. In particular, indirect incentives delivered through the tax system tend to provide limited benefits to firms in loss positions and are unlikely to support early-stage or innovative investors unless designed as refundable or equivalent to negative taxes, underscoring the importance of the mix between direct and indirect fiscal support. Consistent with the principles set out by the Platform for Collaboration on Tax (PCT)—including the emphasis on transparency, targeting, governance, and alignment with development objectives—a more measured and disciplined approach includes:

- **Optimize tax policy.** Encourage investment while safeguarding revenues by maintaining clear, stable, and neutral tax parameters and minimizing frequent changes that raise uncertainty for firms planning long-term projects.
- **Assess incentives ex ante.** Apply clear eligibility criteria, conduct cost–benefit analysis, and include sunset provisions so that incentives are targeted, time-bound, and aligned with broader development objectives.
- **Prioritize targeted, cost-based, tools.** Use measures such as accelerated depreciation, investment allowances, or training-related incentives, which link benefits to actual investment outlays and are generally less distortionary than profit-based exemptions.
- **Maintain sustainable corporate tax systems.** Ensure tax regimes remain competitive while supporting long-term revenue needs, including by setting rates and bases that are predictable, broad-based, and consistent with medium-term fiscal plans.
- **Improve transparency.** Publish regular tax-expenditure reports, disclose the legal basis and objectives of incentive schemes, and enforce provisions consistently to limit discretion and rent-seeking—core elements emphasized in the PCT principles. Complementary efforts to strengthen private-sector transparency, particularly through beneficial-ownership disclosure, can further reduce opacity and corruption risks associated with FDI.

- **Carefully (re-)assess the impact of the global minimum tax on the effectiveness of existing and new tax incentives.** Recognize that simple, neutral, and administratively efficient regimes will become increasingly important as profit-based incentives lose traction under new international tax rules.

69. SEZs may complement broader investment strategies, but they warrant particular caution, as weak implementation can lead to revenue erosion, misallocation toward low-productivity activities, and heightened governance risks. The empirical results indicate that SEZ legislation is associated with higher FDI only in LICs with stronger fiscal discipline or revenue administration capacity, while countries with weaker institutions experience little or no durable gains. This suggests that SEZs are unlikely to substitute for weaknesses in the broader investment climate and, if introduced prematurely, risk generating limited additional investment while imposing fiscal and administrative costs. In low-capacity settings, SEZ regimes can also foster resource misallocation, by diverting capital and labor toward protected or lower-productivity activities, and may operate in corruption-prone environments where discretionary approvals, complex eligibility rules, and weak oversight heighten rent-seeking risks and undermine policy credibility. Where authorities choose to deploy SEZs, frameworks should therefore prioritize strong governance, transparent and rules-based incentive regimes, and close integration with domestic infrastructure and supply chains. Incentives should be time-bound, subject to clear eligibility criteria and regular evaluation, and designed to minimize revenue losses and distortions, preferably grounded in tax laws.

70. Strengthening core institutions, fiscal and other, can help reinforce the effectiveness of policy reforms and support more sustained FDI inflows. Priority areas include:

- **Modernizing revenue administrations.** Tax and customs administrations should prioritize predictability, transparency, and low-cost procedural reforms. Expanding digital filing and payment systems combined with simplified reporting and consolidated payment arrangements applying risk-based audit approaches, introducing advance rulings, and improving taxpayer services can lower compliance costs and reduce uncertainty in the tax system.

- **Enhancing public financial management.** More consistent project appraisal, procurement practices, and budget execution processes can improve the reliability of public investment and clarify the government's capacity to deliver infrastructure.

- **Improving accountability and the rule of law.** Clearer contract enforcement, more secure property-rights frameworks, and measures to address corruption risks can help reduce uncertainties that affect investment decisions.

- **Addressing business-environment constraints.** Strengthening electricity supply, transport networks, land administration systems, and dispute-resolution mechanisms, together with accessible and well-documented data and public information for investors, can improve operating conditions for investors.

71. For resource-rich countries, FDI policy involves both governing extractive investment effectively and leveraging fiscal reforms to shift FDI toward higher-quality, non-enclave activities. Mining-related FDI requires a governance-focused approach, reflecting the sector's substantial upfront capital needs, long project horizons, and exposure to geological and regulatory risks. In this context, location decisions tend to reflect the presence of commercially viable deposits more than tax incentives, consistent with the section's finding of no systematic association between fiscal institutions and low-R&D, non-manufacturing FDI, including mining. Policy priorities should therefore focus on establishing stable and transparent fiscal regimes for extractive industries, including well-structured royalties and profit-based taxes that can help secure an appropriate government share of resource rents (IMF, Fiscal Strategy in Resource-Rich Countries, 2021b; FARI). For LICs, strengthening contracting processes can also help mitigate the risk of unfavorable terms by reducing information asymmetries vis-à-vis large multinational enterprises. Useful steps may include drawing on model contracts, subjecting fiscal terms to multi-agency review, ensuring independent assessment of feasibility studies, and publishing contracts where feasible—principles reflected in the IMF's Guide on Resource Revenue Transparency (2007). Complementary reforms such as streamlining licensing procedures, reinforcing environmental and social safeguards, and designing local content policies that reflect domestic capacity (IMF, 2014) can further enhance governance and sustainability in the mining sector. Beyond the extractive sector, broader fiscal and institutional reforms remain essential for improving the quality, spillovers, and sustainability of investment and for supporting the diversification of FDI toward higher-value, more knowledge-intensive activities outside enclave sectors.

72. Overall, the recommendations point to the value of a sequenced and mutually reinforcing reform strategy. In many LICs, sequencing is important because administrative and human-resource capacity is limited and reforms often carry fiscal and operational costs that must be managed carefully. Measures to strengthen FDI outcomes are therefore more likely to gain traction when macro-fiscal stability and credibility are established first through realistic medium-term planning, transparent reporting, and predictable budget execution. As these foundations deepen, countries can gradually advance institutional reforms—such as improving tax administration, modernizing PFM systems, strengthening contract governance in resource industries, and enhancing regulatory transparency. More targeted, sector-specific reforms, including SEZ design or adjustments to mining fiscal regimes, tend to be more effective once institutional capacity allows for consistent implementation. Subsequent efforts can then focus on improving the broader business environment, supported by regular monitoring and evaluation. Taken together, a phased approach can help reduce uncertainty, foster investor confidence, and create conditions for more resilient and development-enhancing FDI.

73. Looking ahead, LICs are likely to continue to face a challenging external environment for attracting FDI, characterized by heightened global uncertainty, tighter financial conditions, and more selective investor behavior. In this context, strengthening fiscal institutions and policy credibility becomes even more important, as the analysis shows that investors place greater weight on fiscal discipline and fiscal institutions in high-uncertain environments. A small set of pragmatic, near-term reforms—often within reach even under capacity constraints—can deliver

early credibility gains. These include digitalizing core revenue administration functions (such as e-filing, e-payments, and risk-based compliance), clarifying and publishing valuation and exemption rules, and strengthening oversight of tax exemptions—particularly in SEZs and investment schemes. In parallel, targeted GovTech solutions can strengthen governance and transparency across revenue administration, PMF, and procurement. Improving the governance of extractive industries—by limiting discretionary incentives and increasing transparency in contracts and fiscal regimes—is particularly important where mining-related FDI remains dominant. By anchoring expectations and reducing policy and implementation risk, such reforms can support more stable and higher-quality FDI inflows even as global conditions remain volatile.

Annex I. LIC Classification and Aggregation Methodology

For the purposes of this report, LICs are defined as all IMF members that are eligible for borrowing under the Poverty Reduction and Growth Trust (PRGT). This list, updated regularly following a PRGT-eligibility review approved by the IMF Board, currently includes 70 LICs[1]. This LIC classification is different from the definition of Low-Income Developing Countries (LIDC) used in the World Economic Outlook (WEO) and from the LIC classification used by the World Bank.

Throughout this report, the LIC group is further segmented across three dimensions:

1. By income level. LICs are categorized into two groups, mutually exclusive, based on their GNI per capita: (1) at or below the IDA cutoff threshold (US$ 1,325 in FY26, =100 percent), referred to as the *poorest LICs* throughout the report; and (2) countries above the IDA cutoff threshold, referred to as *more advanced LICs*. For analytical consistency with the 2024 Review of PRGT Finances and Facilities, Haiti, Nepal, and Guinea are included in the first group despite having GNI per capita above the IDA cutoff threshold.[2] This grouping differs from the WB definition of the poorest LICs, which is composed of those countries with more than half of their populations below the extreme poverty line (Mawejie 2025).

2. By institutional characteristics. LICs are divided into four institutional groups: (1) *fragile and conflict-affected states (FCS)* that experience political instability, flows of displaced people, or are in an open conflict; (2) *small developing states (SDS)* with populations lower than 1.5 million[3]; (3) *frontier markets (FM)* with access to international financial markets; and (4) *all other LICs*. There are overlaps between some of these categories, that is, some LICs are classified, for example, as both FCS and FM, or FCS and SDS.

3. By export structure. Five mutually exclusive groups can be distinguished, mostly following the World Economic Outlook Country Group classification as of January 2026:

- *Fuel exporters (or fossil fuel exporters)* are countries where net fuel exports make up 30 percent or more of total exports.
- *Non-fuel commodity exporters (or non-fossil fuel exporters)* are resource-intensive countries, other than fuel exporters, whose nonrenewable natural resources represent at least 25 percent of total exports.

[1] Since 2008, 83 countries have been classified as PRGT-Eligible (LICs) over time; 65 of the initial PRGT-eligible members remain on the list to this day. Only 6 countries entered the list since it was established, while 13 graduated to EM status (Table 3). See the IMF (2024a), approved by the Board on October 15, 2024, Annex IX.

[2] This classification reflects the status of these countries under the comprehensive assessment framework established in the 2024 Review of the PRGT Facilities and Financing.

[3] This country group (LIC-SDS) is a sub-group of SDS as defined in the 2024 Staff Guidance Note on the IMF's Engagement with Small Developing States.

- *Diversified countries* that are non-resource-intensive (i.e. those not classified as either fuel or non-fuel commodity exporters), identified in the original WEO classification as having Diversified and Manufacturing export sectors. Countries are included in this category if their dominant categories of exports are manufactured goods or if they have more than one category of exported products.

- *Tourism dependent countries* are those whose export earnings are small, but revenue generated from travel and passenger transport services make up 10 percent or more of total export revenue.

- *Other services countries* are classified as those whose main source of exports are services (including income, transfers) in the original WEO Country Groupings.

Annex I. Table 1. LIC 2026 Classification by Income Level, Export Structure, and Institutional Structure[1]

Income Level[2] / Institutional Characteristics[3]	Most vulnerable LICs <=100	Threshold LICs >100=<150	Wealthier LICs >150<=300	Wealthy LICs >300
FCS	Afghanistan (Non-Fuel), Burkina Faso (Non-Fuel), Burundi (Non-Fuel), Central African Republic (Non-Fuel), Chad (Fuel), Democratic Republic of the Congo (Non-Fuel), Eritrea (Non-Fuel), Guinea-Bissau (Non-Fuel), Haiti (Diversified), Niger (Diversified), Mali (Non-Fuel), Myanmar (Diversified), Somalia (Non-Fuel), Sudan (Non-Fuel), South Sudan (Fuel), Syria (Diversified), Yemen (Fuel)		Zimbabwe (Non-Fuel)	
Frontier	Rwanda (Diversified), Tanzania (Diversified), Togo (Diversified), Zambia (Non-Fuel)	Tajikistan (Non-Fuel), Benin (Non-Fuel), Senegal (Diversified)	Cote d'Ivoire (Diversified), Ghana (Non-Fuel), Honduras (Diversified), Kenya (Diversified), Uzbekistan (Diversified)	
SDS			Bhutan (Diversified), Djibouti (Services), Vanuatu (Tourism)	Cabo Verde (Tourism), Dominica (Tourism), Grenada (Tourism), St. Lucia (Tourism), St. Vincent and the Grenadines (Tourism), Tonga (Services), Samoa (Tourism), Maldives (Tourism)
Other	The Gambia (Services), Lesotho (Diversified), Liberia (Non-Fuel), Madagascar (Diversified), Malawi (Non-Fuel), Sierra Leone (Non-Fuel), Uganda (Diversified), Guinea (Non-Fuel), Nepal (Services)		Bangladesh (Diversified), Lao P.D.R. (Diversified), Mauritania (Non-Fuel), Nicaragua (Diversified), Cambodia (Diversified), Kyrgyz Republic (Services)	Moldova (Services)
FCS and Frontier	Mozambique (Services), Ethiopia (Diversified)	Cameroon (Diversified)	Congo, *Republic of* (Fuel), Papua New Guinea (Non-Fuel)	
FCS and SDS		Comoros (Services), Timor-Leste (Fuel)	Sao Tome (Tourism), Kiribati (Non-Fuel), Solomon Islands (Non-Fuel)	Marshall Islands (Non-Fuel), Micronesia, Fed. States of (Diversified), Tuvalu (Non-Fuel)

1/ The country colors refer to the LIC export structure classifications: Fuel (Red), Non-Fuel Commodity (Green), Diversified & Manufacturing (Blue), Tourism (Yellow) and Services (Black). Fuel and Non-Fuel Commodity countries are resource-rich countries.
2/ The four income columns correspond with the percent of the GNI per capita cutoff for FY2026 of $1325.
3/ FCS and Frontier, and FCS and SDS refer to institutional characteristics and their overlaps.

Annex I. Table 2. Complete Classification Lists

All PRGT Countries (70)	By Export Structure	By Institutional Structure	
Afghanistan			
Bangladesh	**Fuel (5)**	**FCS (31)**	**Others (16)**
Benin	Chad	Afghanistan	Bangladesh
Bhutan	Congo, Republic of	Burkina Faso	Cambodia
Burkina Faso	Timor-Leste 1/	Burundi	Gambia, The
Burundi	Yemen	Cameroon	Guinea
Cabo Verde	South Sudan	Central African Republic	Kyrgyz Republic
Cambodia		Chad	Lao P.D.R.
Cameroon	**Non-fuel (25)**	Comoros	Lesotho
Central African Republic	Afghanistan	Congo, Republic of	Liberia
Chad	Benin	Democratic Republic of Congo	Madagascar
Comoros	Burkina Faso	Eritrea	Malawi
Congo, Republic of	Burundi	Ethiopia	Mauritania
Côte d'Ivoire	Central African Republic	Guinea-Bissau	Moldova
Democratic Republic of Congo	Democratic Republic of Congo	Haiti	Nepal
Djibouti	Eritrea	Kiribati	Nicaragua
Dominica	Ghana	Mali	Sierra Leone
Eritrea	Guinea	Marshall Islands	Uganda
Ethiopia	Guinea-Bissau	Micronesia, Fed. States of	
Gambia, The	Kiribati	Mozambique	
Ghana	Liberia	Myanmar	
Grenada	Malawi	Niger	
Guinea	Mali	Papua New Guinea	
Guinea-Bissau	Marshall Islands	Sao Tome	
Haiti	Mauritania	Solomon Islands	
Honduras	Papua New Guinea	Somalia	
Kenya	Sierra Leone	South Sudan	
Kiribati	Solomon Islands	Sudan	
Kyrgyz Republic	Somalia	Syria	
Lao P.D.R.	Sudan	Timor-Leste, Dem. Rep. of	
Lesotho	Tajikistan	Tuvalu	
Liberia	Tuvalu	Yemen	
Madagascar	Zambia	Zimbabwe	
Malawi	Zimbabwe		
Maldives		**Frontier (17)**	
Mali	**Diversified & Manufacturing (23)**	Benin	
Marshall Islands*	Bangladesh	Cameroon	
Mauritania	Bhutan	Congo, Republic of	
Micronesia, Fed. States of*	Cambodia	Côte d'Ivoire	
Moldova	Cameroon	Ethiopia	
Mozambique	Côte d'Ivoire	Ghana	

Annex I. Table 2. Complete Classification Lists (concluded)

Myanmar
Nepal
Nicaragua
Niger
Papua New Guinea
Rwanda
Samoa
Sao Tome
Senegal
Sierra Leone
Solomon Islands
Somalia
South Sudan*
St. Lucia
St. Vincent and the Grenadines
Syria*
Tajikistan
Tanzania
Timor-Leste, Dem. Rep. of
Togo
Tonga
Tuvalu*
Uganda
Uzbekistan
Vanuatu
Yemen
Zambia
Zimbabwe*

Ethiopia
Haiti
Honduras
Kenya
Lao P.D.R.
Lesotho
Madagascar
Micronesia, Fed. States of
Myanmar
Nicaragua
Niger
Rwanda
Senegal
Syria
Tanzania
Togo
Uganda
Uzbekistan

Tourism (9)
Cabo Verde
Dominica
Grenada
Maldives
Samoa
Sao Tome
St. Lucia
St. Vincent and the Grenadines
Vanuatu

Services (8)
Comoros
Djibouti
Gambia, The
Kyrgyz Republic
Moldova
Mozambique
Nepal
Tonga

Honduras
Kenya
Mozambique
Papua New Guinea
Rwanda
Senegal
Tajikistan
Tanzania
Togo
Uzbekistan
Zambia

SDS (19)
Bhutan
Cabo Verde
Comoros
Djibouti
Dominica
Grenada
Kiribati
Maldives
Marshall Islands
Micronesia, Fed. States of
Samoa
Sao Tome
Solomon Islands
St. Lucia
St. Vincent and the Grenadines
Timor-Leste, Dem. Rep. of
Tonga
Tuvalu
Vanuatu

Note: 5 countries with * were not eligible for financing under the PRGT since its start in 2008. The remaining 65 countries have been PRGT-eligible members since 2008. *Countries in italics blue are currently under a Fund-supported program.*
1/ Timor-Leste's oil and gas production ceased in 2025. It may be reclassified in future WEO publications.

Annex I. Table 3. Classification by Income

Poorest LICs (GNI per capita at or below IDA cutoff of US$ 1,325. US$1,325=100 percent)	More advanced LICs (GNI per capita above IDA cutoff of US$ 1,325. US$1,325=100 percent)		
<=100 (32)	**>100=<150 (6)**	**>150<=300 (20)**	**>300 (12)**
Afghanistan	Benin	Bangladesh	Cabo Verde
Burkina Faso	Cameroon	Bhutan	Dominica
Burundi	Comoros	Cambodia	Grenada
Central African Republic	Senegal	Congo, Republic of	Maldives
Chad	Tajikistan	Côte d'Ivoire	Marshall Islands
Democratic Republic of Congo	Timor-Leste, Dem. Rep. of	Djibouti	Micronesia
Eritrea		Ghana	Moldova
Ethiopia		Honduras	Samoa
Gambia, The		Kenya	St. Lucia
Guinea[1]		Kiribati	St. Vincent and the
Guinea-Bissau		Kyrgyz Republic	Grenadines
Haiti[1]		Lao P.D.R.	Tonga
Lesotho		Mauritania	Tuvalu
Liberia		Nicaragua	
Madagascar		Papua New Guinea	
Malawi		Sao Tome	
Mali		Solomon Islands	
Mozambique		Uzbekistan	
Myanmar		Vanuatu	
Nepal[1]		Zimbabwe	
Niger			
Rwanda			
Sierra Leone			
Somalia			
South Sudan			
Sudan			
Syria			
Tanzania			
Togo			
Uganda			
Yemen			
Zambia			

[1] Haiti, Nepal, and Guinea are classified within the poorest LICs, even though their GNI per capita is above the IDA cutoff, for consistency with 2024 Review of PRGT Finances and Facilities approved by the Board in October 2024.

Annex I. Table 4. Regional Distribution of LICs

AFR (35)	**APD (17)**
Benin	Bangladesh
Burkina Faso	Bhutan
Burundi	Cambodia
Cabo Verde	Kiribati
Cameroon	Lao P.D.R.
Central African Republic	Maldives
Chad	Marshall Islands
Comoros	Micronesia
Congo, Democratic Republic of the	Myanmar
Congo, Republic of	Nepal
Côte d'Ivoire	Papua New Guinea
Eritrea	Samoa
Ethiopia	Solomon Islands
Gambia, The	Timor-Leste
Ghana	Tonga
Guinea	Tuvalu
Guinea-Bissau	Vanuatu
Kenya	
Lesotho	**MCD (10)**
Liberia	Afghanistan
Madagascar	Djibouti
Malawi	Kyrgyz Republic
Mali	Mauritania
Mozambique	Somalia
Niger	Sudan
Rwanda	Syria
São Tomé and Príncipe	Tajikistan
Senegal	Uzbekistan
Sierra Leone	Yemen
South Sudan	
Tanzania	**WHD (7)**
Togo	Dominica
Uganda	Grenada
Zambia	Haiti
Zimbabwe	Honduras
	Nicaragua
EUR (1)	St. Lucia
Moldova	St. Vincent and the Grenadines

Annex I. Table 5. Evolution of PRGT List

	Entrants				Graduates					
2010					Albania	Angola	Azerbaijan	India	Pakistan	Sri Lanka
2013	Marshall Islands	Micronesia	South Sudan	Tuvalu	Armenia	Georgia				
2015					Bolivia	Mongolia	Nigeria	Vietnam		
2017	Zimbabwe[1]									
2020					Guyana					
2024	Syria									

[1] Zimbabwe was not included in the PRGT-eligible list of countries until 2017 due to its overdue financial obligations (arrears) to the Fund, which prevented an assessment against the PRGT eligibility criteria, as the country was not eligible to any form of financing until full clearance of the arrears.

4. This report's LIC universe compared with IDA eligibility: 69 out of the 70 PRGT-eligible IMF members are also eligible for IDA-financing. The remaining nine countries eligible for IDA financing but excluded from PRGT eligibility (and hence this sample) are Belize, Eswatini, Fiji, Guyana, Kosovo, Nigeria, Pakistan, Sri Lanka, and Suriname. Moldova is PRGT-eligible but graduated from IDA eligibility in 2020.

5. This report's LIC universe compared with the WB's coverage in the Global Economic Prospects (GEP) report: Of the 70 PRGT countries, 25 overlaps with the World Bank's list of 26 Low-Income Countries (LICs) from the June 2025 Global Economic Prospects Report. All other LICs covered in this report are included in the general sample of the GEP, which however also includes higher income developing countries.

6. Emerging markets and advanced economies: for emerging markets, the report uses WEO's classification of 'Emerging Market and Middle-Income Economies', excluding PRGT-eligible countries. The list of advanced economies is fully aligned with the WEO classification.

Methodological Note: Aggregation Methodologies used in this report

This report uses several approaches to summarize and present data, aimed at ensuring that the analysis reflects both typical trends and the relative importance of different countries. The methods include medians, averages, and weighted averages. Below is a summary of how these methodologies are applied:

- **Medians:** The median is the middle value in a dataset when all values are arranged in order. It is particularly useful when the data includes extreme values or outliers that could distort the overall picture. This gives a better sense of the "typical" experience within the group, rather than being skewed by a few countries with unusually high or low data outturns relative to the mean. In addition, medians do not assign different weights to countries based on their economic size proxied by their respective GDP.

- **Simple Arithmetic Average:** This is the most common type of average, calculated by adding all the values of observation and dividing this sum by the number of countries in the sample. It is used for data where each country's data point is given equal importance.

- **Weighted averages** are used to reflect the relative economic size or systemic importance of countries when calculating group totals or averages. For data related to aggregate real GDP growth rates, this report uses weights based on GDP measured at purchasing power parity. This method adjusts for differences in price levels between countries, making it more suitable for comparing living standards or economic output across countries.

Annex II. The Role of Global Factors in Driving Net Financial Flows to LICs

1. External financial flows to LICs are a significant source of financing but their composition differs from that in AEs and EMs. In most LICs, FDI and government borrowing are dominant sources while investment through banks and other sectors (mostly trade finance) is much smaller and portfolio flows remain negligible for many LICs. On the asset side, LICs holdings are often concentrated in foreign exchange reserves, banks' deposits abroad, and external receivables. As a result, net inflows (net incurrence of liabilities minus net increase in assets) largely coincide with changes in external liabilities.

2. Miksjuk and Zhang (forthcoming) analyze the role of global factors in driving different types of financial flows to LICs in a standard push-pull panel regression setting. Global push variables include: (i) the VIX index as a proxy for global risk sentiment; (ii) the US Federal Funds rate as a proxy for global interest rates; (iii) non-fuel commodity prices capturing terms-of-trade shocks in LICs (many are commodity exporters); and (iv) global economic growth reflecting external economic environment (see Annex II. Table 1).

Annex II. Table 1. Panel Regressions Estimates across Different Types of Net Financial Flows to LICs in 2012-24

	FDIs	Banks		Other sectors	Government (by sources)			
		Total	Excl. SDS		Total	Multilateral	Bilateral	Private
Global push factors								
Risk sentiment (VIX)	-.16***	-.06	-.11**					
	(.036)	(.040)	(.046)					
Fed rate	-.15***			-.11**	-.13**	.11**	-.22***	
	(.058)			(.051)	(.053)	(.053)	(.047)	
Non-fuel commodity prices	.12**							-.19***
	(.058)							(.055)
Global economic growth					-.10**	-.15***		
					(.043)	(.043)		

Source: Miksjuk and Zhang (forthcoming). "Riding the Global Cycle: How Money Flows into LICs." IMF WP.
Notes: *, **, *** indicate statistical significance at 10%, 5%, and 1% level. All variables have been normalized. Estimates are based on a wide panel (N>T) with lagged country-specific pull factors and cluster-robust standard errors.

3. Global conditions have a statistically significant but heterogeneous impact on FDI, investment flows through banks, and flows through other sectors to LICs. Increase in global risk sentiment (VIX) and increase in the US Federal Funds rate—both reflecting tighter global financial conditions—tend to reduce net FDI inflows to LICs. By contrast, increase in non-fuel commodity prices leads to higher FDI inflows, which may reflect lower risk of investing in these economies or higher returns on investments in specific commodity sectors. Increase in VIX is associated with lower inflows through LICs' banks, although this relationship is not observed in SDS which have faced correspondent banking relationship pressures. Higher US Federal Funds rate leads to significantly lower financial inflows through other sectors.

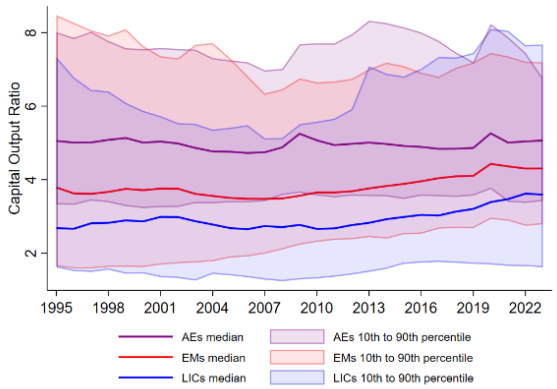
4. External borrowing by LIC governments has a significant counter-cyclical element, although this pattern differs across creditor types. LIC government borrowing is higher during

global economic downturns. Multilateral organizations (even excluding the IMF), increase lending to LICs during the periods of global economic downturn and/or high interest rates, in line with their stabilizing and counter-cyclical role. Bilateral creditors tend to reduce lending during the periods of high interest rates. When non-fuel commodity prices are high (resulting in higher fiscal revenues), LIC governments reduce their exposure to external private lenders.

Annex III. Marginal Product of Capital and International Capital Flows

1. LICs tend to have lower capital–labor and capital-output ratios than advanced economies (Annex III Figure 1), yet they do not benefit from higher capital inflows. Other things equal, low capital ratios should imply higher marginal products of capital (MPKs) in LICs that, in turn, should attract foreign capital, and, in the absence of frictions and policy constraints, induce capital to flow to LICs until in the long run MPKs are equalized across countries. In practice, however, capital does not flow in large scales to poorer countries—a paradox famously identified by Lucas (1990)—and not even to fast-growing LICs (the allocation puzzle). Instead, capital flows between advanced economies (Obstfeld and Taylor, 2004).

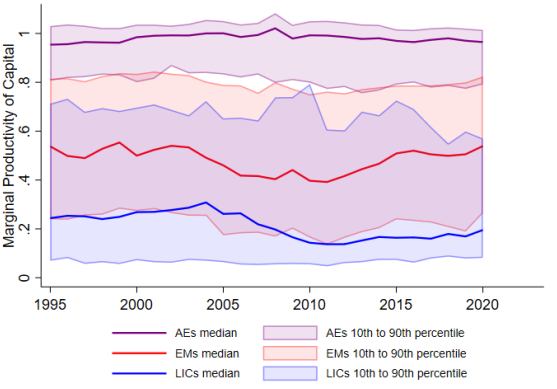
Annex III. Figure 1. Capital Output Ratio
(1995-2023)



Sources: Penn World Table 11.0; IMF staff calculations.

2. Vasilyev, Kangur and Bhuvana Sundar (forthcoming) show that the marginal product of reproducible capital—defined as all man-made assets used in production—has been lower in LICs than in EMs or AEs. They estimate the marginal product of capital (MPK) following the methodology popularized by Caselli and Feyrer (2007), adjusting for higher relative prices of capital, higher endowment of natural wealth, and higher reliance on public capital in LICs. This approach assumes perfect competition in capital markets and constant returns to scale (or linear homogeneity) in production. Under these conditions, MPKs can be inferred from observable data on output (Y), capital stock (K), and capital income share in total income (α=MPK×K/Y) using information from Penn World Tables 11.0 (Feenstra et al., 2015). Information on the share of natural capital is drawn from the World Bank's The Changing Wealth of Nations 2024 database. Following Lowe et al. (2018), public and private MPKs are calculated, drawing on the IMF's Investment and Capital Stock Dataset (ICSD) as well as the methodology presented in An et al. (2019), both of which yield broadly comparable results. The sample covers 34 AEs, 62 EMs, and 29 LICs over the period 1995–2023. A robustness check for total MPK, using data in constant local currency and in current PPPs, yields broadly similar results. Key findings from this work are:

Annex III. Figure 2. Marginal Productivity of Capital Relative to the U.S.
(1995-2020)

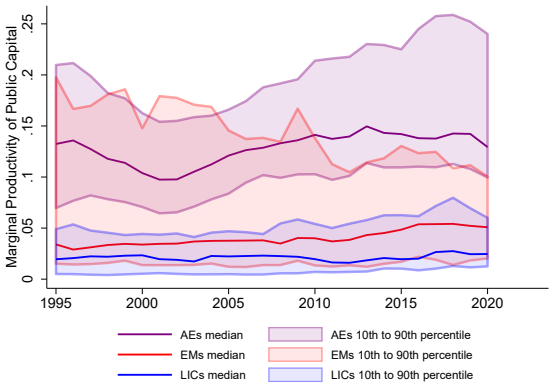


Sources: Penn World Table 11.0, IMF staff calculations.

- During the early 2000s, the differences in MPKs were relatively smaller (earlier studies often found equalization of MPKs at that time). Since then, MPKs have risen across all country groups—largely driven by the relative decline in the cost of capital (Annex III Figure 2).

- However, the gap between LICs and AEs has widened, particularly in the aftermath of the dot-com boom and during the commodity super-cycle. This divergence may reflect heavier investment in IT and digital technologies in AEs, which tend to generate increasing returns to capital, while LICs' investment remained concentrated in commodity-related sectors. Similar trends were observed for public and private capital but the MPK gap between AEs and LICs is more pronounced for public capital (Annex III Figure 3).

Annex III. Figure 3. Marginal Productivity of Public Capital
(1995-2020)



Sources: WEO, Penn World Table 11.0, IMF staff calculations.

3. Research has shown that MPKs are not higher in poorer countries once policies and institutional constraints are accounted for. Lucas (1990) emphasized the role of lower human capital and weaker total factor productivity (TFP) in poorer countries as complementary factors constraining their capital inflows. Caselli and Feyrer (2007) found that, after adjusting for relative prices of capital goods and the share of produced (man-made) capital, MPKs in developing economies and AEs are broadly similar. Hsieh and Klenow (2010) show that relative prices of investment goods (relative to consumption goods) are higher in developing countries because of lower TFP in the investment goods sector. Lowe et al. (2018) further show that the marginal productivity of public capital is systematically lower in LICs compared to AEs, contributing to lower total MPKs. Complementary targeted microeconomic policies such as large asset transfers or substantial loans to liquidity constrained households and microenterprises could similarly help to alleviate domestic barriers that are often associated with multiple equilibria and poverty traps, increasing aggregate returns on capital (Balboni et al. 2022, Bari et al. 2024)

Annex IV. Sovereign Ratings, Capital Flows and Spreads: Are LICs Any Different?

1. The role of sovereign credit ratings in LICs has been far less examined than EMs. Historically, LICs received significantly lower capital flows than EMs, particularly FDI and portfolio inflows (PI).[1] In fact, until the last decade, few LICs were rated and even fewer had market access with sovereign spreads.[2] As more LICs gain market access and ratings, the question arises whether these sovereign credit ratings will be as impactful for LICs as they were for EMs. In EMs, sovereign credit ratings played a key role in supporting capital market access and determining borrowing costs. The ratings helped by reducing information asymmetries and providing investors with a standardized signal of sovereign risk, allowing them to differentiate between countries when allocating capital.[3] At the same time, ratings upgrades contributed to lower borrowing costs for AEs and EMs. These developments led many EMs to obtain a sovereign rating since the 1990s.

2. Against this backdrop, Said and Kangur (forthcoming) examines whether changes in sovereign credit ratings impact spreads, FDI, and portfolio inflows (PI) in LICs. The analysis spans EMs as well as LICs—using a sample of 80 countries, including a sub-sample of rated LICs — over 2000-23. To investigate the impact of changes in sovereign ratings on FDI and PI, the Arellano-Bover/Blundell-Bond Dynamic Panel System (and Difference) GMM estimators are applied to estimate (equation1):

$$\text{Capital Inflows}_{i,t} = \alpha + \beta\text{Capital Inflows}_{i,t-1} + \gamma\text{Domestic}_{i,t} + \mu\text{Global}_{i,t} + \delta\text{Ratings}_{i,t} + \varepsilon_{i,t} \qquad (1)$$

where *Capital Inflows* is the ratio of gross FDI (and portfolio) inflows to GDP of country i at time t, *Capital Inflows* $_{it-1}$ is the AR(1) lagged endogenous variable, and the regressors include domestic "pull" variables, global "push" factors, and normalized sovereign ratings.[4] Given that FDI responds slowly to fundamentals, domestic variables are lagged in those specifications. Global push factors include the VIX index, a measure of US stock market volatility, a proxy for global uncertainty and market sentiment, and the real US interest rate as a proxy for global financial conditions.

To study how changes in sovereign ratings affect sovereign spreads, equation (2) is estimated with

[1] Since the 1990s, EMs have experienced episodes of large surges in capital flows. Chen and Khan (1997), Calvo (1998), Koepke (2015), IMF (2016), Lee and Sami (2019), IMF (2024) and Section I of this report) elaborate on trends in capital flows to EMs and LICs.

[2] For instance, only 27 LICs are rated by Standard and Poor's, and only 12 LICs have sovereign spreads.

[3] Early work by Cantor and Packer (1996), Reinhart (2002), Kraussl (2003) asserted the role played by sovereign ratings in providing more information than what is publicly available, lowering information asymmetries, paving the way for examining sovereign ratings as a determinant of capital flows and sovereign spreads. Sovereign spreads tend to echo the market's perception of sovereign risk and are shaped by both by global as well as domestic factors in EMDEs (Yiptong, et. Al., 2025).

[4] The literature (Hannan, 2017) highlights multiple factors as drivers of capital flows in EMs: both push factors (limited investment opportunities and low interest rates in AEs) and pull factors (comparatively stronger economic performance in some EMs). This analysis uses credit ratings from Standard & Poor's (S&P), which the literature identifies as leading the market (see Gande and Parsley 2004, 2005; Mollemans 2004; Martell 2005).

panel fixed effects that account for unobservable, time-invariant heterogeneity across countries:

$$\text{Spreads}_{i,t} = \alpha + \beta\text{Domestic}_{i,t} + \gamma\text{Global}_{i,t} + \delta\text{Ratings}_{i,t} + \varepsilon_{i,t} \quad (2)$$

where *Spreads* denote the JP Morgan Emerging Market Bond Index Global (EMBIG) spreads.

3. The results of the analysis show that sovereign credit rating upgrades can significantly raise FDI and portfolio inflows and reduce borrowing costs in LICs. For FDI, the results indicate that a one notch rating upgrade results in about 2-3 percent of GDP increase in FDI inflows to LICs, with an even larger effect in the broader EM-LICs sample (Annex IV Table 1). Importantly, for LICs, sovereign credit ratings encapsulate the effect of macroeconomic fundamentals and could help reduce information asymmetries that often hinder LIC's efforts to attract capital inflows. For PI flowing to LICs, a one notch rating upgrade leads to around 1 percent of GDP increase in PI (Annex IV Table 2). These findings are stronger for the broader EM-LICs sample, as well as the EMs sub-sample, reflecting the very small scale of PI inflows to LICs. Robustness checks show that ratings matter more when global uncertainty is higher, especially for LICs. For spreads, the results show that a one notch upgrade (downgrade) in sovereign ratings lowers (increases) spreads by 20-22.5 percentage points with results significant at the 1 percent level (Annex IV Table 3), consistent with Cantor and Packer (1996).

Annex IV. Table 1. Foreign Direct Investment and Sovereign Ratings

	EMs and LICs	LICs	LICs
Global push factors			
Logged VIX index	0.41	0.42	-0.381
	(0.31)	(0.32)	(0.561)
G7 growth rate	0.0632**	-0.0453	-0.0566
	(0.0297)	(0.0564)	(0.0577)
G7 real interest rate	-0.158**	0.0181	-0.280
	(0.0648)	(0.176)	(0.204)
Domestic pull factors (lagged)			
FDI/GDP	-0.0623	-0.582	-0.346
	(0.0872)	(0.527)	(0.270)
Sovereign ratings	6.381**	2.805*	2.428*
	(2.999)	(1.668)	(1.273)
Capital flow restrictiveness	1.324	-4.020	2.980
	(1.630)	(8.768)	(4.084)
Fiscal balance/GDP	0.243*	-0.0719	0.110*
	(0.125)	(0.280)	(0.0648)
Real growth rate			0***
			(0)
Control of corruption			-0.656
			(2.030)
Country FE	NO	NO	NO
Sample period	1990-2023	1990-2023	1990-2023
Number of countries	78	21	20

Note: Robust standard errors in parentheses.

Annex IV. Table 2. Portfolio Inflows and Sovereign Ratings

	EMs and LICs
Global push factors	
Logged VIX index	-0.431*
	(0.235)
G7 growth rate	-0.155**
	(0.0782)
Real US interest rate	-0.201**
	(0.0964)
Real Federal Funds Rate (FFR, 10-year)	0.0774
	(0.138)
Pegged ER dummy * Real FFR	2.339**
	(1.180)
Domestic pull factors (lagged)	
Portfolio inflow/GDP	-0.229*
	(0.120)
Sovereign ratings	1.059***
	(0.356)
Fiscal balance/GDP	-0.115***
	(0.0571)
Country FE	No
Sample period	1990-2023
Number of Countries	80

Note: Robust standard errors in parentheses.

Annex IV. Table 3. Sovereign Spreads and Sovereign Ratings

	EMs - FE	EMs - RE	LICs - FE	LICs - RE
Global push factors (logged)				
VIX index	0.511***	0.511***	0.594***	0.575***
	(0.041)	(0.041)	(0.107)	(0.101)
US Treasury Rate (10-year)	0.032	0.023	0.194**	0.171**
	(0.031)	(0.030)	(0.077)	(0.068)
Domestic pull factors (lagged)				
Sovereign ratings	-0.202***	-0.195***	-0.225***	-0.240***
	(0.010)	(0.007)	(0.029)	(0.019)
Real growth rate	-0.025***	-0.026***	-0.021*	-0.011
	(0.003)	(0.003)	(0.011)	(0.009)
Reserves/GDP	-0.006***	-0.005***	-0.010	-0.006**
	(0.002)	(0.002)	(0.008)	(0.002)
Public debt/GDP	0.002*	0.001	-0.001	-0.002
	(0.001)	(0.001)	(0.002)	(0.002)
Current account balance/GDP	-0.011***	-0.008***	0.003	-0.001
	(0.003)	(0.002)	(0.007)	(0.003)
Country FE	YES	NO	YES	NO
Sample period	1990-2023	1990-2023	1990-2023	1990-2023
R-squared	0.524		0.646	
Number of countries	71	71	12	12
Hausman chi2		15.07		470
Hausman p-value		0.0351		0

Note: Robust standard errors in parentheses

Annex V. Key Findings from "Foreign Direct Investment in Retreat: Policies to Turn the Tide" (World Bank 2025)

1. FDI to EMDEs has fallen sharply since the global financial crisis. After peaking in 2008—on the eve of GFC—global FDI inflows to EMDEs have declined in recent years to the lowest level since the mid-2000s. The retreat has been broad-based across regions and reflects slower trade and investment integration, weaker reform momentum, and rising policy uncertainty and geopolitical tensions. FDI has also become more concentrated in a few large EMDEs—mainly China, India, and Brazil—and has shifted from manufacturing toward services, which now account for nearly two-thirds of inflows. In EMDEs, almost 90 percent of FDI takes the form of greenfield investment, which tends to have stronger domestic growth linkages than mergers and acquisitions.

2. Macroeconomic, institutional, and trade factors are key determinants of FDI. Empirical analysis in the report finds that FDI is strongly influenced by macroeconomic stability, institutional quality, market size, and financial development. Trade integration and participation in global value chains are particularly important: a one-percentage-point increase in trade openness raises FDI inflows by about 0.6 percent, while an investment treaty boosts bilateral FDI by more than 40 percent. In contrast, restrictive investment regulations, weak governance, and geopolitical tensions significantly deter cross-border investment.

3. FDI has positive but heterogeneous growth effects. A 10 percent increase in FDI inflows raises GDP by about 0.3 percent after three years on average, with effects reaching 0.8 percent in economies with stronger institutions, higher human capital, greater openness, and lower informality. The impact of FDI growth on GDP is weaker in LICs as they lag other EMDEs in many of these dimensions.

4. A cohesive policy strategy is needed to address the decline. The World Bank recommends: (i) attracting FDI through stronger institutions, macroeconomic stability, and open trade and investment regimes; (ii) amplifying the benefits of FDI via human-capital development and climate-aligned reforms; and (iii) strengthening global cooperation to sustain a rules-based investment system and support LICs with limited capacity.

Annex VI. Empirical Framework and Results on the Determinants and Dynamics of FDI in LICs

This annex documents the empirical framework and supporting results used to assess how fiscal discipline, fiscal incentives, fiscal institutions, and broader institutional settings are associated with FDI flows in low-income countries (LICs). It first describes the baseline gravity-model specification and presents the main gravity results, followed by robustness checks, alternative specifications, and joint specifications using principal component analysis (PCA) to assess the relative importance of fiscal discipline, fiscal institutions, and broader institutional settings. The annex then introduces a local-projection (LP) framework to analyze the dynamic response of FDI to selected fiscal and institutional reforms, including both discrete tax-reduction episodes and complementary estimates based on changes in the marginal effective tax rate (METR) of the corporate income tax (CIT).

A. Gravity Model

1. FDI inflows to LICs are volatile, highly concentrated among a small number of partner economies, and shaped by persistent institutional constraints. A bilateral gravity framework provides a tractable way to assess how macro-fiscal conditions, fiscal institutions, and economic fundamentals are associated with FDI inflows while controlling for global shocks and time-invariant cross-country differences. The analysis employs a Poisson pseudo–maximum likelihood (PPML) estimator, which accommodates zero flows, is robust to heteroskedasticity, and allows for a rich fixed-effects structure suited to LIC data.

Data

2. The gravity-model analysis is based on a bilateral panel combining bilateral FDI flows with standard gravity covariates and a set of macro-fiscal and institutional indicators tailored to LICs. Data sources and variable definitions are summarized in Table 6.5.

- **Bilateral FDI flows.** Bilateral FDI inflows are drawn from the World Bank's Harmonized Bilateral FDI (HBFDI) database, which reconciles asymmetries in balance-of-payments reporting to produce directionally consistent flow data. This harmonization is particularly important for LICs, where reporting gaps, methodological breaks, and data inconsistencies are common. The sample covers 2000–2019, allowing analysis of medium- to long-run patterns in an environment where FDI is volatile and highly concentrated among a limited number of partner economies.

- **Bilateral frictions.** Standard time-invariant dyadic gravity variables from CEPII—including geographic distance and a shared official language—are used to proxy persistent bilateral frictions. These variables also provide internal validity checks, as their estimated coefficients are expected to align with canonical gravity-model predictions.

- **Macro-fiscal and institutional indicators.** To capture host- and source-country fundamentals relevant for FDI decisions in LICs, the HBFDI–CEPII core dataset is complemented with the following variables:
  - **Macroeconomic conditions.** GDP (PPP, constant international dollars), GDP per capita (in US$), real GDP growth, and human capital are used to characterize market size and economic fundamentals relevant for FDI decisions.
  - **Fiscal discipline.** Indicators to gauge the credibility and consistency fiscal policy management, proxied by the public debt-to-GDP ratio and CPIA indicators capturing the quality of fiscal policy formulation and debt policy and management.
  - **Fiscal incentives.** Indicators capturing the use of fiscal policy tools to attract FDI, including tax-reduction episodes and the adoption of Special Economic Zone (SEZ) legislation.
  - **Fiscal institutions.** Indicators of institutional capacity in public finance, including CPIA measures of the quality of budgetary and financial management, efficiency of revenue mobilization, and fiscal transparency and accountability, as well as those of revenue administration, proxied by ISORA indicators on operational strength and digitalization.
  - **Broader institutional settings.** Governance and legal environment indicators, including a composite governance index created with a PCA using the six key Worldwide Governance Indicators and rule of law, and capital account openness measured by the Chinn–Ito index.

Econometric Specification

The empirical analysis adopts the following PPML gravity specification:

$$E\left[FDI_{ijt} \,\middle|\, Z, X, G\right] = \exp\left(\alpha_t + \gamma_i + \delta_j + \beta_1 X^{host}_{i\,t\,or\,t-1} + \beta_2 Z^{source}_{j\,t\,or\,t-1} + \beta_3 G^{bilateral}_{i,j\,t}\right)$$

Where:

FDI_{ijt} denotes inflows from source j to host i in year t
$X^{host}_{it\,or\,t-1}$ includes host-country fundamentals
$Z^{source}_{jt\,or\,t-1}$ captures source-country fundamentals
G_{ij} contains bilateral frictions
α_t, γ_i, and δ_j are year, host, and source fixed effects

3. This fixed-effects structure preserves the time variation needed to identify within-country changes in macro-fiscal and institutional variables, while allowing bilateral frictions to be identified from cross-pair differences. At the same time, it does not capture time-varying or localized factors—such as subnational security conditions, conflict dynamics, or project-level business-environment and return considerations—that may also influence FDI decisions, particularly in fragile and conflict-affected states. Accordingly, the estimated relationships should be interpreted as conditional associations rather than causal effects.

4. To limit multicollinearity among closely related fiscal and broader institutional variables, the gravity model is estimated using a sequential specification strategy. The analysis starts from a baseline gravity model that includes standard determinants of bilateral FDI—host- and source-country GDP, geographic distance, a common official language, host- and source-country human capital, GDP per capita, real GDP growth, and top statutory CIT rates. Building on this baseline, fiscal discipline variables, fiscal institutional indicators, and broader institutional settings are then added one by one, rather than jointly. This stepwise approach allows the marginal contribution of each group of variables to be assessed while preserving sufficient identifying variation and mitigating collinearity concerns.

Gravity Results

5. The gravity analysis proceeds in four steps: a baseline specification, a robustness check using high-dimensional fixed effects, an augmented specification that includes trade openness, and joint specifications using principal components to assess the relative importance of fiscal discipline, fiscal institutions, and broader institutional settings.

Baseline Gravity Specification

6. Annex VI table 1 reports PPML estimates for EMDEs and LICs based on the preferred specification with year, host-country, and source-country fixed effects. All macroeconomic variables are lagged one period to mitigate simultaneity concerns.

Annex VI. Table 1. Gravity Model Results-Baseline

	EM	LIC
L. GDP (PPP US$, log) - Host	1.520***	1.335***
	(0.275)	(0.354)
L. GDP (PPP US$, log) - Source	1.028***	1.603***
	(0.262)	(0.302)
Distance (log)	-0.757***	-0.991***
	(0.061)	(0.073)
Common official language dummy	1.060***	0.767***
	(0.139)	(0.120)
L.Human capital per capita (constant 2014 th USD) - Host	0.002	0.055**
	(0.005)	(0.027)
L.Human capital per capita (constant 2014 th USD) - Source	0.003*	0.005**
	(0.002)	(0.002)
L. GDP per capita (US$) - Host	-0.015**	-0.067
	(0.007)	(0.068)
L. GDP per capita (US$) - Source	0.005	-0.009
	(0.009)	(0.014)
L. Real GDP growth - Host	0.014*	0.021***
	(0.007)	(0.008)
L. Real GDP growth - Source	-0.013	-0.015
	(0.010)	(0.013)
Top combined CIT rate - Host	-0.007	0.005
	(0.006)	(0.010)
Top combined CIT rate - Source	0.017***	0.010
	(0.006)	(0.013)
Constant	5.970**	5.411**
	(2.650)	(2.625)
Time fixed effect	yes	yes
Source- and Host-country fixed effect	yes	yes
Observations	75,456	36,984
Pseudo R-squared	0.685	0.553

Notes: EM excludes China. Standard errors are shown in parentheses and are clustered at the host-source country pair level. Statistical significance s indicated as follows: ***p<0.01, **p<0.05, *p<0.10.

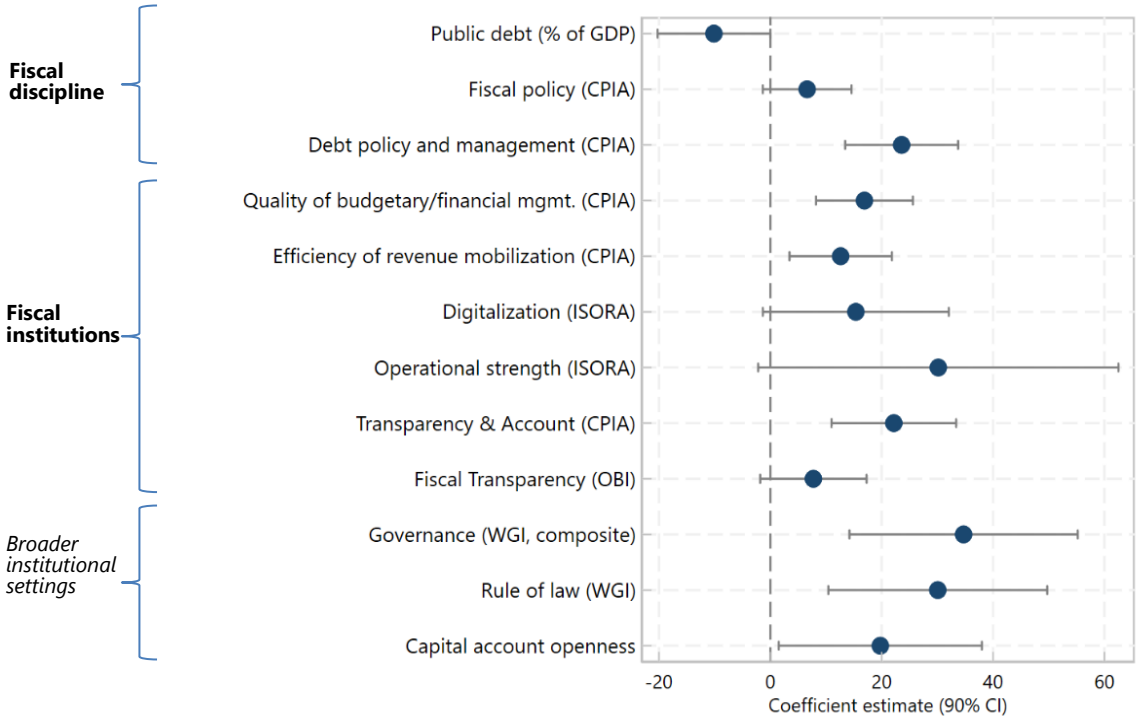
7. Standard gravity relationships hold across specifications: larger host and source economies are associated with higher bilateral FDI flows, distance is negatively related to investment, and a shared official language is positively correlated with FDI. These patterns are consistent with the gravity literature and validate the merged HBFDI–CEPII dataset.

8. Annex VI figure 1 summarizes the baseline gravity results for LICs, highlighting the role of fiscal discipline, fiscal institutions, and broader institutional settings in shaping FDI inflows. A one–standard-deviation increase in public debt is associated with an estimated decline in FDI of about 14 percent, whereas comparable improvements in fiscal discipline and fiscal institutions are associated with increases in FDI on the order of 10–20 percent.

- **Fiscal discipline.** Higher public debt is associated with lower FDI inflows, while stronger CPIA ratings for fiscal policy and debt management are positively associated with investment.
- **Fiscal institutions.** Stronger PFM, revenue mobilization, fiscal transparency, and revenue administration capacity (CPIA and ISORA) are positively associated with FDI inflows.

- **Broader institutions.** Governance, rule of law, and capital account openness are generally positively correlated with FDI, though with less consistent statistical significance.

Annex VI. Figure 1. LICs: Marginal Effects of Host-Country Fiscal and Institutional Variables on FDI: Baseline



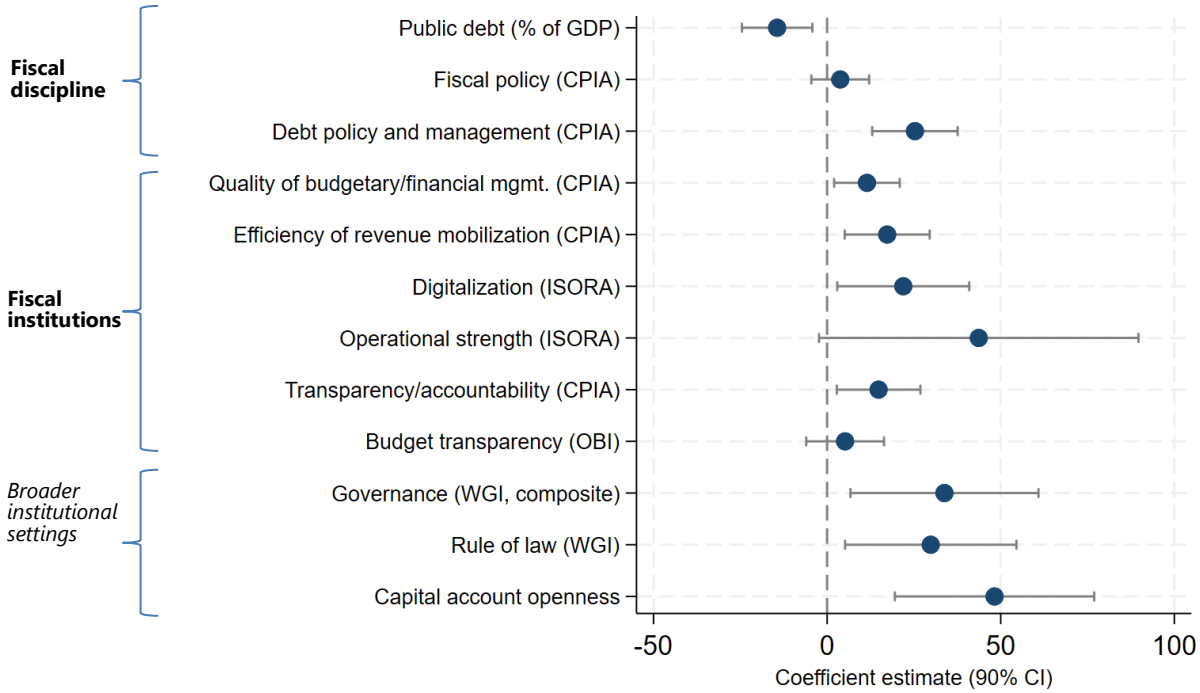
Notes: results are reported as marginal changes in expected FDI, scaled to a one-standard-deviation increase in fiscal and institutional variables.

Alternative Specification with High-Dimensional Fixed Effects

9. As a robustness check, the baseline model is re-estimated using an alternative fixed-effects structure with source-country–year and host–source (pair) fixed effects. This specification absorbs all time-varying source-country push factors and all time-invariant bilateral characteristics.

10. Annex VI figure 2 shows that the estimated marginal effects for LICs remain broadly consistent with the baseline results. Fiscal discipline indicators, fiscal institutional variables (including CPIA and ISORA measures), and broader governance indicators retain their expected signs and similar magnitudes, while public debt remains negatively associated with FDI. These results suggest that the baseline findings are not driven by omitted bilateral relationships or unobserved source-country factors.

Annex VI. Figure 2. LICs: Marginal Effects of Host-Country Fiscal and Institutional Variables on FDI: Alternative Specification with High-Dimensional Fixed Effects



Notes: results are reported as marginal changes in expected FDI, scaled to a one-standard-deviation increase in fiscal and institutional variables.

Including Trade Openness in the Baseline Specification

11. Motivated by the gravity-model literature, which often includes trade openness as a proxy for global integration, the baseline specification is augmented to include trade openness for both host and source countries.

12. As shown in Annex VI Table 2, including trade openness does not materially alter the main results. The estimated coefficients on fiscal discipline, fiscal institutional quality, governance indicators, and public debt remain similar in magnitude and statistical significance. Trade openness itself is not robustly associated with FDI inflows for LICs once fixed effects and other macro-fiscal controls are included.

Annex VI. Table 2. Gravity Model Results—with Trade Openness

	EM	LIC
L. GDP (PPP US$, log) - Host	1.582***	1.293***
	(0.292)	(0.368)
L. GDP (PPP US$, log) - Source	0.974***	1.760***
	(0.275)	(0.317)
Distance (log)	-0.735***	-1.010***
	(0.062)	(0.080)
Common official language dummy	1.048***	0.771***
	(0.139)	(0.122)
L. Trade openness - Host	0.006**	0.000
	(0.002)	(0.003)
L. Trade openness - Source	-0.003*	0.004
	(0.002)	(0.003)
L.Human capital per capita (constant 2014 th USD) - Host	-0.000	0.051*
	(0.005)	(0.027)
L.Human capital per capita (constant 2014 th USD) - Source	0.004**	0.005*
	(0.002)	(0.003)
L. GDP per capita (US$) - Host	-0.011	-0.045
	(0.007)	(0.073)
L. GDP per capita (US$) - Source	0.002	-0.005
	(0.008)	(0.016)
L. Real GDP growth - Host	0.011	0.025***
	(0.008)	(0.009)
L. Real GDP growth - Source	-0.008	-0.014
	(0.009)	(0.014)
Top combined CIT rate - Host	-0.007	0.002
	(0.006)	(0.011)
Top combined CIT rate - Source	0.020***	0.008
	(0.006)	(0.014)
Constant	5.600*	4.258
	(2.892)	(2.806)
Time fixed effect	yes	yes
Source- and Host-country fixed effect	yes	yes
Observations	73,561	34,730
Pseudo R-squared	0.684	0.555

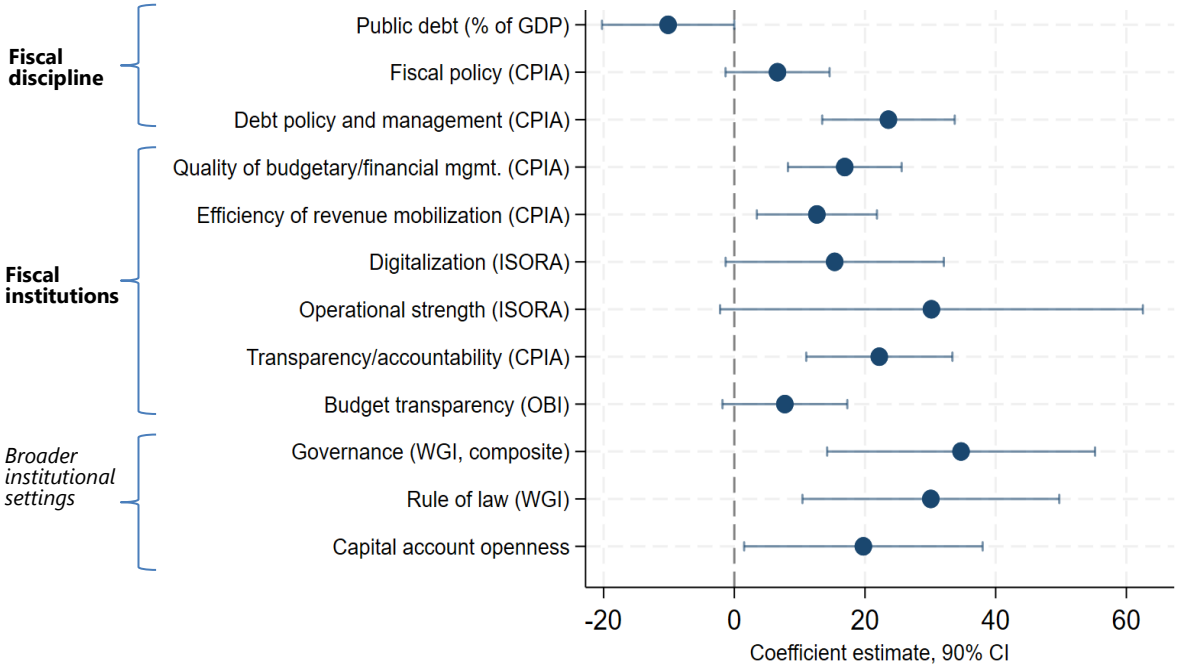
Notes: EM excludes China. Standard errors are shown in parentheses and are clustered at the host-source country pair level. Statistical significance s indicated as follows: ***p<0.01, **p<0.05, *p<0.10.

13. Annex VI Figure 3 confirms that the marginal effects of fiscal and institutional variables for LICs are essentially unchanged when trade openness is added to the model. Statutory CIT differentials remain statistically insignificant, while most measures of fiscal governance and institutional capacity continue to display economically meaningful associations with FDI.

Although the estimated effects for the CPIA efficiency of revenue mobilization and ISORA digitalization indicators marginally cross the zero line at the 90 percent confidence level, their magnitudes and signs remain consistent with the baseline specification, and the qualitative conclusions of the analysis are broadly unchanged.

Annex VI. Figure 3. LICs: Marginal Effects of Host-Country Fiscal and Institutional Variables on FDI:

Alternative Specification with Trade Openness



Notes: results are reported as marginal changes in expected FDI, scaled to a one-standard-deviation increase in fiscal and institutional variables.

14. Including country—specific measure of uncertainty in the gravity specification yields results that are broadly consistent with standard gravity predictions. The World Uncertainty Index (WUI) provides a country-specific measure of uncertainty. The main purpose of incorporating WUI is to assess whether the importance of fiscal discipline, fiscal institutions, and broader institutional settings for attracting FDI varies with host-country uncertainty, by interacting WUI with these institutional variables (reported in the main text), rather than to identify a direct average effect of uncertainty. Annex VI Table 3 presents the baseline gravity results: larger host and source economies are associated with higher bilateral FDI inflows, distance is negative, and a common official language is positive, while host human capital and real GDP growth are positively correlated with FDI. The coefficients on lagged host and source WUI are not statistically significant once year, host, and source fixed effects are included.

Annex VI. Table 3. LICs: Gravity Model Results—with World Uncertainty Index

L. GDP (PPP US$, log) - Host	1.358***
	(0.353)
L. GDP (PPP US$, log) - Source	1.539***
	(0.315)
Distance (log)	-0.989***
	(0.075)
Common official language dummy	0.768***
	(0.125)
L.Human capital per capita (constant 2014 th USD) - Host	0.096*
	(0.050)
L.Human capital per capita (constant 2014 th USD) - Source	0.004
	(0.004)
L. GDP per capita (US$) - Host	-0.066
	(0.068)
L. GDP per capita (US$) - Source	-0.005
	(0.017)
L. Real GDP growth - Host	0.019**
	(0.008)
L. Real GDP growth - Source	-0.016
	(0.014)
Top combined CIT rate - Host	0.006
	(0.010)
Top combined CIT rate - Source	0.007
	(0.013)
L.World Uncertainty Index (WUI) - Host	0.063
	(0.176)
L.World Uncertainty Index (WUI) - Source	-0.300
	(0.225)
Constant	5.586**
	(2.838)
Time fixed effect	yes
Source- and Host-country fixed effect	yes
Observations	31,994
Pseudo R-squared	0.543

Notes: Standard errors are shown in parentheses and are clustered at the host-source country pair level. Statistical significance s indicated as follows: ***p<0.01, **p<0.05, *p<0.10.

15. Figure 35 in the main text is based on gravity regressions that explicitly allow the effect of fiscal and institutional variables to vary with country-specific uncertainty, measured by the WUI. The estimated specification can be written schematically as:

$$\mathrm{FDI}_{ijt} = \beta_X X_{it} + \beta_U U_t + \beta_{XU}(X_{it} \times U_t) + \Gamma Z_{ijt} + \mathrm{FE} + \varepsilon_{ijt},$$

where $U_t$denotes the standardized WUI, $Z_{ijt}$is the set of baseline gravity controls, and FE denotes the full set of fixed effects. The marginal effect of a fiscal or institutional variable Xon expected FDI is therefore given by:

$$\frac{\partial E[\mathrm{FDI}]}{\partial X} = \beta_X + \beta_{XU}\, U.$$

Figure 35 shows this marginal effect at two points of the uncertainty distribution: low uncertainty, defined as the 10th percentile of the standardized WUI, and high uncertainty, defined as the 90th percentile. The reported confidence intervals are constructed using the delta method, which accounts for the variance of both $\beta_X$and β_{XU}, as well as their covariance.

Joint Gravity Estimates Using Principal Components of Fiscal and Institutional Variables

16. To further assess the relative importance of fiscal discipline, fiscal institutions, and broader institutional settings while addressing multicollinearity, the gravity model is augmented with principal components for three institutional buckets (Annex VI Table 4). When entered individually, the principal components for fiscal discipline, fiscal institutions, and broader institutional settings are each positively and statistically significantly associated with FDI inflows. However, in pairwise specifications that include fiscal institutions, both fiscal discipline and broader institutional settings lose statistical significance. When all three—fiscal discipline, fiscal institutions, and broader institutional quality—are included jointly, fiscal institutions emerge as the more important institutional correlate of FDI. Finally, when fiscal discipline and broader institutional settings are included as a pair, broader institutional settings remain statistically.

Annex VI. Table 4. LICs. Joint Gravity Results—with Principal Components of Fiscal and Institutional Variables

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
L.Gross domestic product PPP constant (log) - Host	1.301***	1.385*	1.217***	1.396*	1.276***	1.418*	1.420*
	(0.388)	(0.819)	(0.385)	(0.822)	(0.392)	(0.837)	(0.838)
L.Gross domestic product PPP constant (log) - Source	1.412***	1.413***	1.436***	1.410***	1.422***	1.406***	1.403***
	(0.360)	(0.430)	(0.359)	(0.431)	(0.362)	(0.433)	(0.433)
Distance (log)	-1.005***	-0.985***	-1.007***	-0.985***	-1.007***	-0.986***	-0.986***
	(0.074)	(0.078)	(0.074)	(0.078)	(0.074)	(0.077)	(0.077)
Common official language dummy	0.748***	0.743***	0.745***	0.743***	0.744***	0.737***	0.737***
	(0.123)	(0.138)	(0.125)	(0.138)	(0.125)	(0.142)	(0.142)
L.Human capital per capita (constant 2014 th USD) - Host	0.046*	0.076	0.049*	0.073	0.047*	0.082	0.079
	(0.028)	(0.068)	(0.027)	(0.068)	(0.027)	(0.067)	(0.068)
L.Human capital per capita (constant 2014 th USD) - Source	0.005*	0.005**	0.005**	0.005**	0.005**	0.005**	0.005**
	(0.002)	(0.003)	(0.003)	(0.003)	(0.002)	(0.003)	(0.003)
Top Combined CIT Rate - Host	0.016	0.024	0.010	0.025	0.015	0.023	0.025
	(0.012)	(0.020)	(0.012)	(0.020)	(0.012)	(0.020)	(0.020)
Top Combined CIT Rate - Source	0.009	0.009	0.010	0.009	0.009	0.010	0.009
	(0.014)	(0.016)	(0.015)	(0.016)	(0.015)	(0.016)	(0.016)
L.WEO: Gross domestic product - Host	-0.000	-0.000	-0.000	-0.000	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
L.WEO: Gross domestic product - Source	-0.000	-0.000	-0.000	-0.000	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
L.WEO: Gross domestic product - Host	0.015	0.014	0.017*	0.013	0.015	0.017	0.017
	(0.009)	(0.013)	(0.009)	(0.013)	(0.009)	(0.012)	(0.013)
L.WEO: Gross domestic product - Source	-0.019	-0.032**	-0.017	-0.032**	-0.017	-0.030**	-0.030**
	(0.013)	(0.014)	(0.013)	(0.014)	(0.013)	(0.014)	(0.014)
Fiscal Discipline	0.128***		...	0.027	0.079		0.030
	(0.042)			(0.058)	(0.049)		(0.059)
Fiscal Institutions		0.171***	...	0.161***		0.175***	0.166***
		(0.056)		(0.060)		(0.063)	(0.064)
Broader Institutional Settings			0.157***		0.112*	-0.010	-0.018
			(0.050)	...	(0.059)	(0.096)	(0.098)
Constant	7.359**	5.519	7.617**	5.529	5.339	5.529	5.383
	(2.977)	(4.980)	(2.990)	(4.984)	(5.000)	(4.984)	(5.000)
Time fixed effect	yes	yes	yes	yes	yes	yes	yes
Source- and Host-country fixed effect	yes	yes	yes	yes	yes	yes	yes
Observations	36,167	24,388	35,992	24,388	24,158	24,388	24,158
Pseudo R-squared	0.557	0.550	0.556	0.550	0.550	0.550	0.550

Notes: Standard errors are shown in parentheses and are clustered at the host-source country pair level. Statistical significance s indicated as follows: ***p<0.01, **p<0.05, *p<0.10.

B. Local Projections

17. While the gravity framework captures medium-run associations between country characteristics and FDI, policymakers are often interested in the dynamic response of FDI to discrete policy reforms. To this end, the analysis employs local projections (LPs) following Òscar Jordà (2005), which allow estimation of impulse response functions (IRFs) without imposing restrictive assumptions on the underlying dynamic adjustment process. This approach is well suited to LIC contexts, where reforms occur infrequently, panel lengths are limited, and medium-term investment responses are of primary policy relevance.

Data

18. The LP analysis uses the same core LIC panel as the gravity model and focuses on within-country reform episodes, coded at the annual frequency. The sample is restricted to PRGT-eligible countries. Policy shocks include:

- **SEZ legislation:** adoption of laws establishing Special Economic Zones (Open Zone Consulting);
- **Tax-burden reductions:** episodes of meaningful reductions in the overall CIT burden (FAD tax-policy changes database).

19. To assess heterogeneity, countries are split by indicators of fiscal discipline (CPIA fiscal policy rating) and fiscal institutional capacity (ISORA-based revenue administration operational strength).

Econometric Specification

For each horizon h = 0, 1, ..., 6, the following regression is estimated:

$$y_{i,t+h} = \alpha_i + \lambda_t + \sum_n lag(y_{i,t}, n) + \beta_h shock_{i,t} + \omega_h X_{i,t-1} + \epsilon_{i,t+h}$$

Where:

$y_{i,t+h}$: FDI inflows (real US$) for country i from time t−1 to time t+h up to h = 6

$lag\ (y_{i,t,}n)$: Lags of FDI inflows (n=2)

α_i: Country FE

λ_t: Time FE

$shock_{i,t}$: Policy reform indicator (binary event or continuous measure), including SEZ legislation adoption (event); tax burden reduction

$X_{i,t-1}$: A vector of control variables (real GDP growth, GDP in PPP US$, human capital, public debt, top statutory CIT rate)

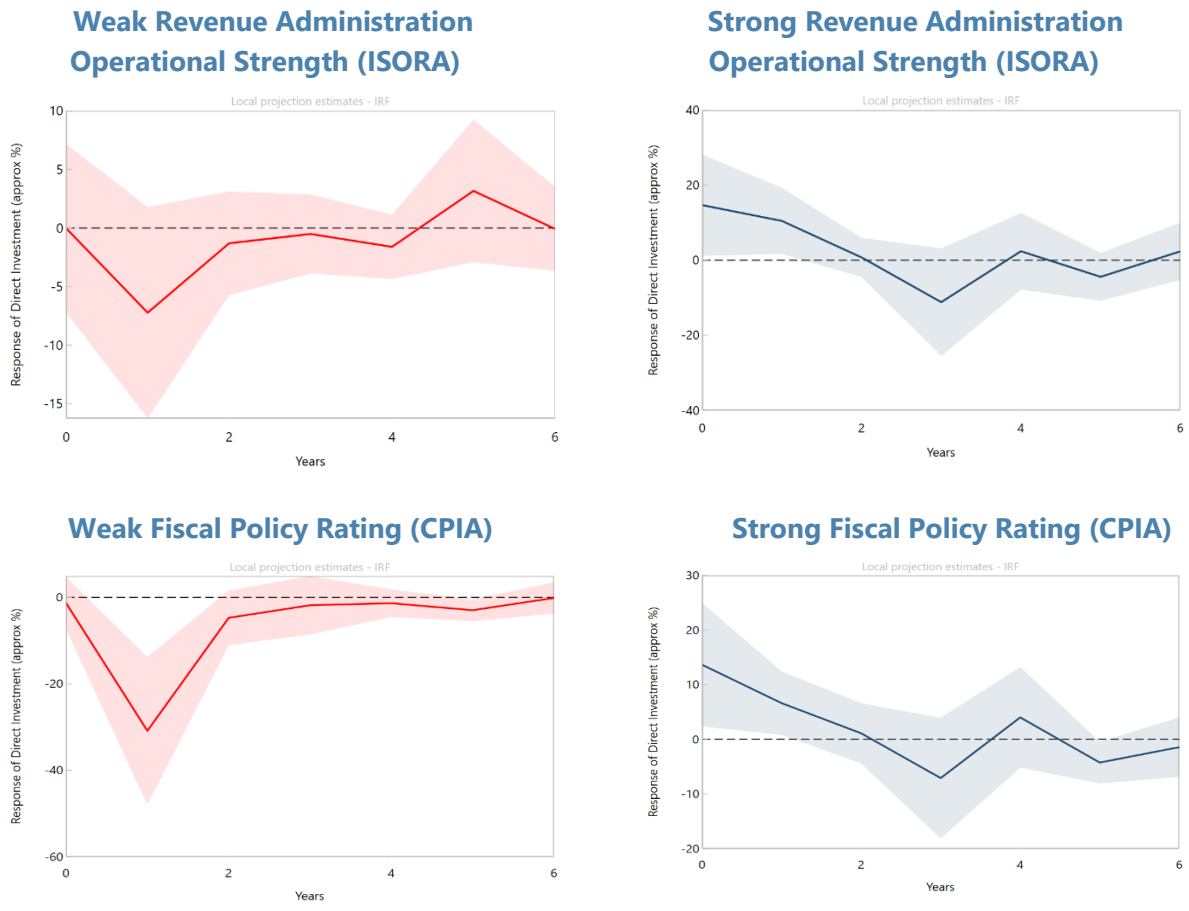
$\epsilon_{i,t+h}$: Error term

Country fixed effects absorb time-invariant structural characteristics, while year fixed effects control for global shocks. Lagged outcomes and pre-reform controls mitigate bias from persistence and gradual adjustment. Standard errors are clustered at the country level. The sequence of estimated βh coefficients traces the impulse response of FDI to a reform shock over a six-year horizon, allowing for flexible, horizon-specific dynamics without imposing a parametric transition structure.

20. Annex VI Figure 4 presents complementary LP estimates based on reductions in the METR of the CIT, using the dataset of Hebous and Mengistu (2025). The specification differs slightly from the baseline through the inclusion of the lagged value of the shock variable as an additional covariate. Unlike the tax-reduction episodes in the main text—which capture discrete

reforms affecting a broad range of taxes—changes in the CIT METR may reflect both policy actions and non-policy factors. With this caveat, the results suggest that reductions in the CIT METR are associated with positive but modest short-run FDI responses in LICs with stronger revenue administration and fiscal discipline, while responses in weaker-capacity LICs are statistically insignificant or counterintuitive, reinforcing the main-text conclusions.

Annex VI. Figure 4. LICs: Impact of Reductions in the CIT Marginal Effective Tax Rate



Note: These charts show impulse response functions estimated using Jordà local projections to assess the heterogeneous impact of selected fiscal reforms on direct investment for countries with above- and below-median CPIA fiscal policy ratings. Lines indicate point estimates and shaded areas denote 90 percent confidence intervals. Year 0 is the year of the shock.

Annex VI. Table 5. Data Sources

Variables	Description	Source
FDI data	Direct investment data representing cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy.	IMF BoP Statistics
Bilateral FDI data	World Bank Group Harmonized Bilateral FDI data available from 2000 to 2019 for 251 economies around the world.	World Bank Harmonized Bilateral FDI database
Orbis Cross-border Investment	Proprietary project-level FDI data. Available from 2003 to 2024.	Moody's Crossborder Investment
Macroeconomic indicators	Including GDP, GDP growth, GDP per capita, inflation, public debt, trade, exchange rates, population.	IMF World Economic Outlook
Fiscal Transparency	Indicator measuring budget transparency, public participation, and oversight at the central government.	IBP Open Budget Index
Fiscal Rules	Binary indicator equal to 1 if the country has fiscal rules of four main types: expenditure rules, revenue rules, budget balance rules, and debt rule.	IMF Fiscal Rules Dataset
Top combined CIT rate	Corporate income tax rates data (IMF internal database).	IMF's Tax Rate Database (DART)
ISORA operational strength index	Operational Strength Index measures the overall strength of tax administration practices, institutional framework, and structural foundations based on nine ISORA indices.	Atsebi et al. (2025)
ISORA degree of digitalization	Degree of digitalization measures the practices and systems that support the use of digital technologies in business processes, such as the availability of e-filing and e-payment options, e-services, and advanced digital technologies.	
Chinn-Ito capital account openness index	A de jure measure of capital account openness based on IMF AREAER restrictions, as constructed by M. Chinn and H. Ito (updated to 2022).	Chinn and Ito (2006)
Governance	Authors' calculations, based on a principal component analysis (PCA) of the six WGI pillars (voice, stability, effectiveness, regulation, rule of law, corruption control).	
CPIA fiscal policy rating	Fiscal policy rating (1=low to 6=high) assesses the short- and medium-term sustainability of fiscal policy (considering monetary and exchange rate policy and the sustainability of the public debt) and its impact on growth.	World Bank Country Policy and Institutional Assessments

Annex VI. Table 5. Data Sources		
CPIA debt policy rating	Debt policy rating (1=low to 6=high) assesses whether the debt management strategy is conducive to minimizing budgetary risks and ensuring long-term debt sustainability.	World Bank Country Policy and Institutional Assessments
CPIA efficiency of revenue mobilization rating	Efficiency of revenue mobilization rating (1=low to 6=high) assesses the overall pattern of revenue mobilization - not only the de facto tax structure, but also revenue from all sources as actually collected.	
CPIA quality of budgetary and financial management rating	Quality of budgetary and financial management rating (1=low to 6=high) assesses the extent to which there is a comprehensive and credible budget linked to policy priorities, effective financial management systems, and timely and accurate accounting and fiscal reporting, including timely and audited public accounts.	
CPIA transparency and accountability	Assesses the extent of fiscal transparency, public access to budget information, and accountability and oversight mechanisms, based on the availability, timeliness, and comprehensiveness of published budget documents (1 = low to 6 = high).	
WGI rule of law	Captures perceptions of the extent to which agents respect and follow the rules of society, including contract enforcement, property rights, the police, courts, and the likelihood of crime and violence.	World Bank Worldwide Governance Indicators
Tax burden reduction episodes	Binary variable that indicates whether the country implemented a tax reform that was expected to reduce overall tax collection at the time of approval.	IMF Global tax Policy and Revenue Evaluation Database (TAPRED)
SEZ legislation	Binary indicator equal to 1 in years in which legislation governing SEZs is approved or amended, and 0 otherwise.	Adrianople Group Open Zone Map
Human capital	Human capital is calculated as the present value of future earnings for the working population, categorized by age, gender, and education. The values are reported in real chained 2014 US dollars.	Wealth Accounting, World Bank
World Uncertainty Index	Index capturing uncertainty related to economic and political developments in short- and long-term; available 1996 onwards.	World Uncertainty Index

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INTERNATIONAL MONETARY FUND

March 13, 2026

MACROECONOMIC DEVELOPMENTS AND PROSPECTS IN LOW-INCOME COUNTRIES—2026—SUPPLEMENTARY INFORMATION

Prepared By

Strategy, Policy, and Review Department

This supplement reports on recent developments and information that became available since the 2026 Macroeconomic Developments and Prospects in Low-Income Countries report was issued to the Board on February 19, 2026.

1. The latest conflict in the Middle East has triggered a negative supply shock that intensified uncertainty and downside risks for the global economy since the publication of the report. It has already resulted in higher and more volatile energy prices, disruptions in trade and regional economic activity, and financial market volatility. It is too early to assess the economic impact on the region and the global economy. That impact will depend on the extent and duration of the conflict, including the degree of disruption to energy and fertilizer production and trade routes. Staff is closely monitoring and evaluating the developments. A comprehensive assessment will be provided in the 2026 April World Economic Outlook, as warranted by developments.

2. If the conflict were to persist, it could generate significant spillovers to LICs. The extent of the spillovers on LICs as a group, and on each individual country, will depend on developments in key channels, such as commodity prices, notably oil and natural gas, alongside other commodities, second round effects on inflation and inflation expectations, global financial conditions, and exchange rate pressures. Remittances could also be affected, given that GCC countries account for 16.4 percent of remittance inflows to LICs. Another potential spillover channel is disruptions to fertilizer supply, given the importance of Gulf producers, with knock on effects on agricultural production and food prices. The impact will likely be most severe for net fuel and food commodity importers, LICs with high external financing needs, and limited policy space.

3. The policy agenda laid out in the report remains pertinent and, if anything, becomes even more urgent in this evolving global context. Countries should pursue macroeconomic stabilization policies tailored to address the implications of the shock while maintaining focus on structural reforms to increase returns on capital and attract stronger FDI inflows to navigate challenging external financing environment. Strong support from the international community will be critical, especially for the poorest LICs and FCS which have limited access to affordable external financing, shallow domestic financial markets, and weakest ability to absorb additional shocks.