The Next Frontier

Low-income countries gain ground in a globalized world, but they still face major challenges

Masood Ahmed

BY THE time East Africa's biggest initial public offering debuted in June, shares in Kenya's Safaricom mobile phone company were oversubscribed by more than 500 percent. With over 860,000 shareholders, Safaricom now has the widest shareholder base of any Kenyan company. Media reports said growth potential for the sector is high, because only a third of Kenyans have a mobile phone. Just eight years ago, fewer than 1 percent of Kenyans had a mobile phone.

Throughout the developing world—from the rice paddies of Vietnam to the tropical coastline of Mozambique—countries are making strides in their drive to raise living standards, becoming in the process the next frontier for investors. In Vietnam, the income poverty rate declined from about 58 percent in 1993 to about 16 percent in 2006, and some 34 million people have been lifted out of poverty; while in Mozambique, infant mortality has been cut from 126 per thousand in 2000 to 96 per thousand in 2006.

Given the now near-universal consensus that sustained faster growth is essential for reducing poverty in poor countries, the recent economic performance of many low-income countries, especially in Africa, has been most encouraging. Underlying sub-Saharan Africa's average economic growth of 5.6 percent in 2003–07 are better economic policies (a far cry from the stop-go economic policies that resulted in little or no growth and high inflation through much of the 1980s and 1990s) and improved terms of trade resulting from the most favorable international economic environment since the 1960s.

But this is only one side of the story (see Box 1 on diversity among low-income countries). For the "bottom billion" (Collier, 2007) of this world, the prospects still look bleak. In some sub-Saharan countries, particularly the conflict-ridden "fragile" states with weak institutional structures, it increasingly seems that the economic and social targets embedded in the Millennium Development Goals (MDGs) will not be met. Even South Asia, which is expected to contribute most to global poverty reduction in the next decade, is likely to fall short in meeting agreed targets on primary education, gender parity in tertiary education, and child mortality and malnutrition.

Are these projected outcomes inevitable? No. They depend on how low-income countries respond and how effectively the rest of the world supports their efforts. This article identifies four major macroeconomic policy challenges facing low-income countries today—tackling rising food and fuel prices, making the changing face of aid work to their advantage, developing a stronger private sector and deeper financial markets, and strengthening the quality of their institutions. Some of these challenges do not look new—they are not. But defined by history, timing, and location, they have taken on particular nuances and emphases. Addressing them by implementing the right policies will also require sensitivity to the history, context, and traditions of each country.

Tackling soaring food and fuel prices

Tackling the economic and social impact of soaring food and fuel prices is an immediate priority for low-income countries, some of which are at a tipping point as they confront higher inflation, balance of payments problems, and worsening poverty. These developments threaten to undermine several of the gains made recently by these countries.

Higher food prices have a larger direct effect on the purchasing power of poor households, because these households typically spend more than half of their income on food, compared with less than 10 percent on fuel. The urban poor are the worst affected. When poor families are unable to feed themselves adequately, the share of the undernourished can rapidly rise, and malnutrition among children and pregnant women can have lasting consequences on human development. And, as the report of the Commission on Growth and Development (2008) points out, malnutrition can also affect long-term growth by lowering productivity.

"Higher food prices have a larger direct effect on the purchasing power of poor households, because these households typically spend more than half of their income on food, compared with less than 10 percent on fuel."

Without a timely and targeted collective response, the rise in global food prices could result in an additional 100 million people in low-income countries falling beneath the poverty line. The responses need to focus on immediate and long-term measures. The first priority is for the international community to help poor countries cover additional financing needs from higher food import bills and the fiscal cost of actions that help the poor. The most affected countries

Box 1

What are low-income countries?

Economists often use the label "low-income countries" as shorthand for countries whose average per capita income is below a certain threshold. The World Bank, for instance, puts 49 countries in this grouping; a citizen in one of these countries earns, on average, less than $935 (in 2007 terms) a year, although significant income inequalities mean that many people earn much less than this amount and some can earn many times more. Like all income- or GDP-based groupings, this label has its advantages (one of which is it allows us to discuss, in a somewhat less fragmented way, the shared problems facing these countries), but it belies the profound diversity of these countries. This diversity is related both to static factors of circumstance—for example, geography—and to more dynamic factors of economic progress—that is, how they have fared in their journey toward development (see table).

It is useful then to think of "low-income countries" not in terms of a monolith but a spectrum of development. In terms of their economic performance over the past decade, about a quarter of these countries have seen at least a 50 percent increase in average incomes, another half have seen some improvement in their living standards, while the remaining countries have seen their average incomes stagnate or fall. The idea of a spectrum helps to highlight the unique social and economic contexts and circumstances of low-income countries, but it should not obscure the countries' shared economic goal: to raise the living standards of their people through broad-based economic growth and poverty reduction, thereby providing a life of dignity and opportunity to all.

Along a spectrum

Low-income countries are diverse in many ways, including the rates at which they have grown.

Real GDP per capita growth, 1997–2007	Country
More than 50%	Chad, Cambodia, Myanmar, Mozambique, Nigeria, Sierra Leone, Tajikistan, Vietnam
25%–50%	Bangladesh, Burkina Faso, Ethiopia, The Gambia, Ghana, Kyrgyz Republic, Lao P.D.R., Madagascar, Mali, Nepal, Pakistan, São Tomé & Príncipe, Tanzania, Uzbekistan
0%–24%	Benin, Kenya, Guinea, Malawi, Mauritania, Niger, Rwanda, Senegal, Uganda, Republic of Yemen, Zambia
Less than 0%	Burundi, Central African Rep., Comoros, Dem. Rep. of Congo, Côte d'Ivoire, Eritrea, Guinea-Bissau, Haiti, Liberia, Papua New Guinea, Solomon Islands, Togo, Zimbabwe

Sources: IMF, International Financial Statistics database; and World Bank.
Note: Data not available for Afghanistan, Democratic People's Republic of Korea, and Somalia.

should lower food prices for the poor and the vulnerable through temporary, targeted subsidies or increased aid. But, at the same time, countries should minimize introducing policies that distort prices and prevent achieving market-led solutions in the longer run. This means avoiding untargeted subsidies to lower domestic food prices, direct price controls, or export bans—all of which tend to be a disincentive for producers and could ultimately result in heightened inflationary pressures.

The food and fuel hikes are part of a broader boom that has also seen prices of many other commodities reach new highs. These price spirals have brought a number of macroeconomic management challenges to the fore. First, they have contributed to ***a worrisome build-up in inflationary pressures.*** Headline inflation continues to rise in many countries, which can particularly affect the countries that spend more on food than on other goods by a large margin. Because a quick return to cheap food and fuel prices is unlikely, inflation fears could keep rearing their head. A key policy challenge is to maintain the hard-won gains of bringing down inflation—and inflationary expectations—into single digits.

Second, ***higher food and fuel prices can have a big balance of payments impact*** (see table). According to recent IMF research (2008a and 2008b), the negative impact on many food- and fuel-importing low-income countries has been quite severe—in many cases well over 2.5 percent of GDP and, in the case of Liberia, about 15 percent of GDP, representing nearly all of its international reserves. Although some countries have been able to absorb the impact of price hikes on their balance of payments in the short term because of higher export earnings or capital inflows that have helped finance commodity imports, projections show that in about half of the African countries, the increase in the cost of food imports could exceed 1 percent of GDP in 2008. Such increases are the highest in some of the poorest countries, such as Eritrea and The Gambia (more than 2 percent).

Third, ***although soaring commodity prices have benefited commodity exporters in the short term, they have also strained the capacity of budget management systems to ensure that the commodity-generated revenue is utilized effectively and transparently.*** These countries need to maintain macroeconomic stability while dealing with rising foreign exchange inflows. Fortunately, many of them are determined to avoid the damaging macroeconomic effect of boom-bust commodity prices that sometimes characterized the lax management of past cycles. A number of countries are setting up special arrangements to use these (possibly temporary) resources for maximum long-term advantage.

Finally, ***given that food prices are likely to remain high for some years, low-income countries should seize this opportunity to encourage the expansion of domestic agricultural production.*** Investing in and improving infrastructure, distribution, and storage systems; increasing efficiency through competition; providing a stable regulatory environment and access to financing; and removing trade barriers can all help in enhancing agricultural productivity. In fact, Ravallion and van de Walle (see "Land and Poverty in Reforming East Asia" on p. 38 in this issue) underscore the importance of agrarian reforms in reducing poverty in both Vietnam and China and the lessons this holds for other low-income countries.

Hardest hit

Strong food and oil price shocks are having a big balance of payments impact in many low-income countries in sub-Saharan Africa.

	BOP impact as percent of GDP			
	Food	Oil	Other commodities	**Total shock**
Liberia	–4.5	–11.1	0.3	**–15.3**
Guinea-Bissau	–1.1	–7.6	0.0	**–8.8**
Eritrea	–2.4	–6.1	–0.1	**–8.6**
Comoros	–2.7	–2.9	–0.9	**–6.5**
Togo	–0.4	–5.6	0.6	**–5.5**
Gambia, The	–2.7	–2.3	0.0	**–5.1**
Malawi	–0.8	–2.9	–1.0	**–4.7**
Sierra Leone	–0.9	–3.7	0.1	**–4.4**
Guinea	–1.6	–3.6	1.0	**–4.2**
Madagascar	–0.7	–3.1	0.0	**–3.7**
Burundi	–0.4	–3.9	0.9	**–3.4**
Ethiopia	–0.8	–2.6	0.4	**–3.0**
Burkina Faso	–0.3	–2.7	0.5	**–2.5**
Central African Rep.	–0.8	–1.8	0.1	**–2.4**
Benin	–0.6	–2.0	0.3	**–2.2**
Congo, Dem. Rep.	–1.5	0.0	0.0	**–1.5**
Zimbabwe	–0.4	–1.7	0.8	**–1.3**

Sources: Adapted from IMF (2008b); UN Comtrade; IMF, World Economic Outlook database; and IMF staff calculations.

Note: The balance of payments (BOP) impact is calculated as the trade balance change resulting from changes in the terms of trade for each country. It measures the effect of the expected increase in prices of exports and imports in 2008, compared with 2007 (volumes of trade are as of 2007), as a share of GDP. The oil prices used in the calculations are $71.1 a barrel in 2007 and $112 a barrel in 2008. Data as of June 30, 2008.

Making aid work better

The second challenge is to make aid more effective. About half the low-income countries continue to depend heavily on external aid to finance their development programs. After nearly two decades of stagnation, aid volumes have begun to rise significantly in recent years, and a concerted international effort is attempting to make aid more effective in reducing poverty and promoting development. Many new donors have entered the development financing arena. This scaling up of aid has brought fresh opportunities for recipient countries, but also put pressure on donors and recipients to make sure that aid is used and managed effectively (see "Improving the Effectiveness of Aid" on p. 15 in this issue).

The emergence of "nontraditional" bilateral donors (that is, those who are not members of the OECD's Development Assistance Committee, or DAC), global funds, private foundations, corporations, and nongovernmental organizations is changing the donor landscape. The non-DAC bilateral donors, which outnumber the 23 DAC donors, include Brazil, China, India, Malaysia, Russia, Venezuela, Saudi Arabia and other oil-rich countries in the Middle East, as well as some recent members of the European Union. Together these donors are estimated to have provided more than $12 billion in financing in 2006. According to some estimates, China and India are providing about $3 billion in combined aid a year, and both are developing larger aid programs.

Alongside new donor countries, global funds that are focused on specific objectives, especially in the health sector, are fast becoming prominent vehicles for the delivery of financing and programs. Integrating these "vertical funds" into a country-based "horizontal delivery infrastructure" is a priority for aid effectiveness. And private donors, including major foundations, are also contributing a substantial amount of aid. For instance, the Bill & Melinda Gates Foundation alone provided more than $2 billion in grants in 2007. In addition, according to OECD estimates, nongovernmental organizations in DAC countries are providing a significant amount of funding.

These new players are bringing additional financing, fresh ideas, and new business models into development financing. But the proliferation of donors with smaller shares of total aid is also raising issues of more effective project selection and aid delivery and management (Kharas, 2007). For instance, the average number of donors per country increased from 12 in the 1960s to about 33 during 2001–05. There are more than 230 international organizations, funds, and programs that provide aid—more than the number of developing countries they are meant to assist. Managing aid flows from many different donors is difficult for recipient countries with insufficient administrative capacity, because different donors insist on using their own processes for implementing and monitoring projects. This points to the need for donors to ***harmonize aid procedures*** to deliver better-quality aid that can be better managed by recipient countries.

The Paris Declaration on Aid Effectiveness, adopted in 2005 by donor and recipient countries, sets out 56 commitments for better delivery and management of aid. Its implementation has already spurred important reforms of the aid system, though a lot remains to be done for donor programs to be effectively aligned behind country-based priorities (see "A Work in Progress" on p. 20 in this issue). Key issues are aligning aid priorities better with recipient country goals, ensuring continued debt sustainability, and making aid more predictable (see "Managing Aid Surprises" on p. 34 in this issue). From the recipients' perspective, it is important that the countries that have recently benefited from debt relief ensure that, in accessing increased financing, they don't build up unsustainable debt burdens again.

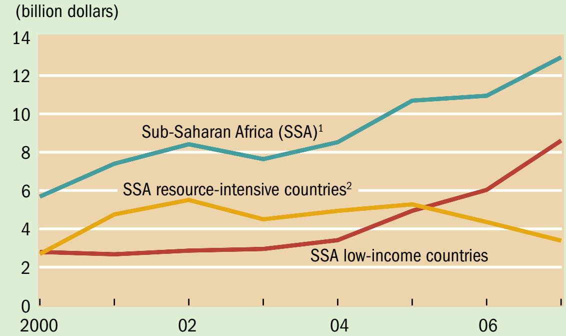
Creating a good business climate

The third big challenge is to develop a business climate that will support a vibrant and competitive private sector, which will create jobs and sustain broad-based growth. Part of the solution to this challenge is to develop liquid and well-functioning domestic capital markets that can support private sector growth.

Stronger integration with global financial markets represents an important opportunity for low-income countries to raise foreign capital and channel it to finance growth-enhancing development. In sub-Saharan Africa, private capital flows have grown almost fivefold in the past seven years: from $11 billion in 2000 to $53 billion in 2007. Such flows have increased rapidly since 2004 to low-income countries as a group, although they have decreased to resource-intensive low-income countries (see chart). And between 2001 and 2007, foreign direct investment (FDI) has remained stable at $15–$21 billion (IMF, 2008c).

Rising flows

Private capital flows to low-income countries in sub-Saharan Africa have been increasing.



Source: IMF (2008c).
[1]Excludes South Africa and Nigeria.
[2]Excludes Nigeria.

A number of countries in sub-Saharan Africa in fact are achieving a "frontier emerging market" status as their financial markets mature sufficiently to permit portfolio investment by international investors (see "The Rise of Africa's 'Frontier' Markets" on p. 30 in this issue). Consider Ghana. It entered the global capital market in September 2007 with a $750 million bond issue that was more than four times oversubscribed. With terms similar to those for Ghana, Gabon issued $1 billion in bonds to repay its Paris Club debt.

Several African countries that have made significant progress toward macroeconomic stability and debt sustainability have also succeeded in selling treasury bills in their own currency to foreign investors. At the end of June 2007, foreigners held more than 14 percent of domestic currency government debt in Zambia, 11 percent in Ghana, and a significant share of such debt in Tanzania and Uganda (Wakeman-Linn and Nagy, 2008).

But although some African countries are doing well, progress is uneven. Indeed, data show that although the share of private capital flows to sub-Saharan Africa is growing, such flows are neither evenly spread across countries nor large or diversified, particularly if FDI is excluded (Ratha, Mohapatra, and Plaza, 2008). After all, between 2000 and 2007, South Africa and Nigeria accounted for nearly half of the FDI, and South Africa accounted for more than 85 percent of the portfolio inflows (IMF, 2008c). And for many low-income countries, official aid flows and inward official sector FDI by state-owned entities of other governments still account for the bulk of external capital flows.

To attract more investment and outside capital, countries need to liberalize their economies. Creating the right policy framework and developing a sequenced liberalization strategy are critical to successfully integrating with the global economy. But opening up the economy to outside capital flows has its risks—and here low-income countries can learn from the experience of today's emerging market economies.

Instituting well-designed capital account policies and financial liberalization strategies is a multistep process. In the short term, it involves reviewing capital account regulations to enhance transparency, consistency, and efficiency. In the medium term, a well-sequenced and well-timed liberalization strategy is needed—longer-term and more stable flows should be liberalized first, leaving enough time for implementing robust regulatory and supervisory frameworks for private sector financial institutions to take root. In addition, countries should have in place the ability to monitor capital inflows. Only then would a full lifting of existing controls be appropriate.

Low-income countries need to strengthen all aspects of local debt and equity market development—from the legal and the regulatory to the infrastructural. By developing the appropriate currency borrowing (and creditor) mix, countries can play a key role in enhancing the depth and liquidity of these markets, and in creating healthy conditions for corporate borrowers to access markets.

Strengthening institutions

The fourth challenge is to improve the institutions needed to foster development (see, for example, the 2005 report of the Commission for Africa). It is now broadly accepted that a key to development lies in the quality of a country's political, legal, and economic institutions. Research has shown that institutions can matter far more than geography (see Acemoglu, Johnson, and Robinson, 2008; and Rodrik, 2004), but also that quality institutions are as much a result of economic prosperity as they are its cause.

The relationship of good institutions and economic prosperity may not always be linear or straightforward, but it is clear that weak institutions undermine the political will or means necessary to put in place appropriate policies or implement key reforms. Also, stable political and legal structures in which property rights are enforced are critical in attracting investors, as is a degree of equality in society that allows different segments to participate in economic life (Acemoglu, 2003). More, and better, investment is one of the main ingredients of sustained growth.

Low-income countries have implemented important political and institutional reforms in recent years. Many of these countries have switched to democratic institutions and multiparty elections. According to the report of the Commission on Growth and Development (2008), "In many countries [in sub-Saharan Africa], if not most, a new generation of leaders is in power, committed to growth and to more open and accountable government. Institutions have also improved in a number of places." But more remains to be done in many of these countries.

Although many nations face serious institutional challenges, the international community has focused on so-called fragile states—countries characterized by weak institutional capacities and governance, social tension, and political instability—in

Box 2

The IMF's role in low-income countries

With more than one billion people still living on less than $1 a day, extreme poverty remains a critical issue for the international community, especially in the low-income IMF member countries—which are two-fifths of its total membership.

The IMF is committed to supporting low-income countries in making progress on eradicating extreme poverty, achieving the Millennium Development Goals, and moving toward middle-income status through its three key functions—lending, technical assistance, and economic surveillance and policy advice.

The IMF's focus is on macroeconomic and financial stability, which are the underpinnings of sustained growth and poverty reduction. Within this overall focus, work in individual countries reflects their specific needs and economic circumstances. The IMF recognizes that the countries themselves lead their development goals and efforts, and that it must work closely with a broader group of donors and agencies in providing this support.

Lending. About 80 percent of the IMF's lending programs are with low-income countries. The IMF provides concessional financing to poor countries facing balance of payments problems through the Poverty Reduction and Growth Facility and, for temporary needs arising from external shocks, through the Exogenous Shocks Facility. For countries that do not need financial assistance, the Policy Support Instrument underpins the design of effective economic programs and signals IMF endorsement to donors, multilateral development banks, and markets. Many low-income countries are also eligible for initiatives aimed at reducing external debt. Countries that have obtained debt relief are spending, on average, four times as much on social services than on debt service.

Technical assistance. The IMF provides assistance and training to help member countries strengthen their capacity to run good fiscal, monetary, exchange rate, and debt policies. On average, the IMF sends four times more technical assistance missions a year to low-income countries than to the rest of its members. In recent years, the IMF has reinforced its efforts by establishing regional technical assistance centers in the Pacific; the Caribbean; East, West, and Central Africa; and the Middle East.

Surveillance. Low-income countries benefit from the regular advice on macroeconomic policies that the IMF provides to all 185 members. The IMF is also strengthening its tools to help these countries reap the full benefits of globalization while managing its risks, for instance, by providing support in other areas that are critical to growth, particularly trade, and by making financial sector analysis an integral part of its policy advice in the surveillance of individual economies.

other words, countries caught in the conflict and bad governance traps (Collier, 2007). Fragile states have 9 percent of the developing world's population but 27 percent of the extreme poor (living on less than $1 a day). International organizations use different measures to judge fragility, generally combining aspects of the capacity and accountability of institutions with indicators related to conflict risks. In 2006, the World Bank identified 35 countries as fragile.

"Eradicating extreme poverty can be achieved only if countries that are now poor sustain many years of faster growth and if the benefits of this growth are shared broadly among their populations."

Such states increasingly lag behind other low-income countries in terms of growth and development. In 2007, the World Bank–IMF's *Global Monitoring Report* estimated that, by 2015, extreme poverty levels in fragile states will have risen to more than 50 percent. It is also important to note that while development assistance to fragile states rose from $9.7 billion to $26.2 billion between 2002 and 2006, these flows are very uneven. In 2005 and 2006, two-thirds of the aid was concentrated in four countries—Afghanistan, Democratic Republic of Congo, Nigeria, and Sudan.

Fragile states are often unable to mobilize sufficient international support at the critical early stages of their reform efforts, although technical assistance efforts can help post-conflict economies in restoring the functioning of some of their key institutions (see Box 2). For instance, as part of its capacity-building efforts, the IMF worked extensively with the Bank of Rwanda—the country's main supervisor and regulator of the financial sector—to help the bank restore its core functions, following the collapse of the country's economy and financial sector in the wake of the 1994 genocide. Beyond technical assistance, a good example of globally coordinated action was the recent success in reducing Liberia's debt after its ruinous 14-year civil war period.

The challenges ahead

Eradicating extreme poverty is a first-order challenge for our generation. This can be achieved only if countries that are now poor sustain many years of faster growth and if the benefits of this growth are shared broadly among their populations. Recent work by many economists and development specialists has shown that although the precise drivers of growth vary across countries, and national leadership plays a key role, there are lessons to be drawn from international experience in what is likely to work and what is not. For some low-income countries, the challenges ahead appear daunting. But it is worth remembering that many of the countries that are now emerging markets faced similar prospects a decade or two ago.

This article focused on some key challenges that macroeconomists and financial specialists will need to address in low-income countries and in the international development community as it tries to help these nations. Other specialists—for instance, health and education professionals, and infrastructure and environmental specialists—will need to work in their complementary domains because growth and development entail progress on a broad spectrum of fronts. Good macroeconomic and financial management is the necessary foundation for these broader efforts. And mobilizing the broad support and the political will to achieve these goals is a cause in which we all can participate. ■

Masood Ahmed is the Director of the IMF's Middle East and Central Asia Department. He headed an IMF Working Group on Low-Income Countries in 2007.

References:

Acemoglu, Daron, 2003, "Root Causes," Finance and Development, *Vol. 40 (June), pp. 27–30.*

———, Simon Johnson, and James Robinson, 2008, "Institutions as the Fundamental Cause of Long-Run Growth" in Handbook of Economic Growth, *Vol. 1A, ed. by Phillipe Aghion and Steven Durlauf (Amsterdam: North Holland).*

Collier, Paul, 2007, The Bottom Billion: Why the Poorest Countries Are Failing and What Can Be Done about It *(Oxford: Oxford University Press).*

Commission for Africa, 2005, "Our Common Interest: Report of the Commission for Africa" (March).

Commission on Growth and Development, 2008, "The Growth Report: Strategies for Sustained Growth and Inclusive Development" (Washington: World Bank).

IMF, 2008a, "Food and Fuel Prices—Recent Developments, Macroeconomic Impact, and Policy Responses"; http://www.imf.org/external/np/pp/eng/2008/063008.pdf

———, 2008b, "The Balance of Payments Impact of the Food and Fuel Price Shocks on Low-Income African Countries: A Country-by-Country Assessment"; http://www.imf.org/external/np/pp/eng/2008/063008a.pdf

———, 2008c, "Private Capital Flows to Sub-Saharan Africa: Financial Globalization's Final Frontier?" in Regional Economic Outlook: Sub-Saharan Africa *(Washington).*

Kharas, Homi, 2007, "Trends and Issues in Development Aid," Wolfensohn Center for Development Working Paper No. 1 (Washington: Brookings Institution).

Ratha, Dilip, Sanket Mohapatra, and Sonia Plaza, 2008, "Beyond Aid: New Sources and Innovative Mechanisms for Financing Development in Sub-Saharan Africa," Policy Research Working Paper 4609 (Washington: World Bank).

Rodrik, Dani, 2004, "Getting Institutions Right" (Unpublished; Cambridge, Massachusetts: Harvard University).

Wakeman-Linn, John, and Piroska Nagy, 2008, "More Investors Turn to Sub-Saharan Africa," IMF Survey Magazine online*; http://www.imf.org/external/pubs/ft/survey/so/2008/CAR012A.htm*