Background Note by IMF Staff
for the United Nations MDG Summit

Reaching the MDGs

Macroeconomic Prospects & Challenges in Low-Income Countries

The views expressed in the background note are those of the staff and do not necessarily reflect the views of the Executive Board of the IMF.

Reaching the MDGs: Macroeconomic Prospects and Challenges in Low-Income Countries

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September 2010

Key Points

- *The crisis has set back progress toward the MDGs. To regain momentum, a broad range of policy actions will be required. Above all, it is vital that strong and sustained global economic growth be restored. Both developed and developing countries will need to play their part in this endeavor.*
- *Further actions by advanced and dynamic emerging market economies are called for to safeguard the global recovery, create a more robust financial system, and improve market access for low-income countries' (LICs) exports.*
- *LICs face massive financing needs to close the "infrastructure gap" and address climate change—both impediments to long-term development. Aid commitments should be fulfilled, but can meet only part of these needs. Countries need to mobilize and use domestic resources more effectively, create conditions to attract FDI, and strengthen their capacity for "safe borrowing."All these should aim at engendering private sector-led growth.*
- *The global crisis has shown that, to achieve the MDGs, LICs need to complement pro-growth strategies with policies that build resilience to shocks. Buffers built up through good macroeconomic policies in recent years, together with scaled up financial support from the Fund and others, allowed developing countries to take strong countercyclical measures and helped them weather the crisis relatively well. The Fund is working with countries to rebuild these policy buffers, and has reformed its own lending instruments and policies, all of which will help increase resilience to future shocks.*
- *Intensified international collaboration is needed to ensure that fragile states do not get left behind in progress toward the MDGs.*

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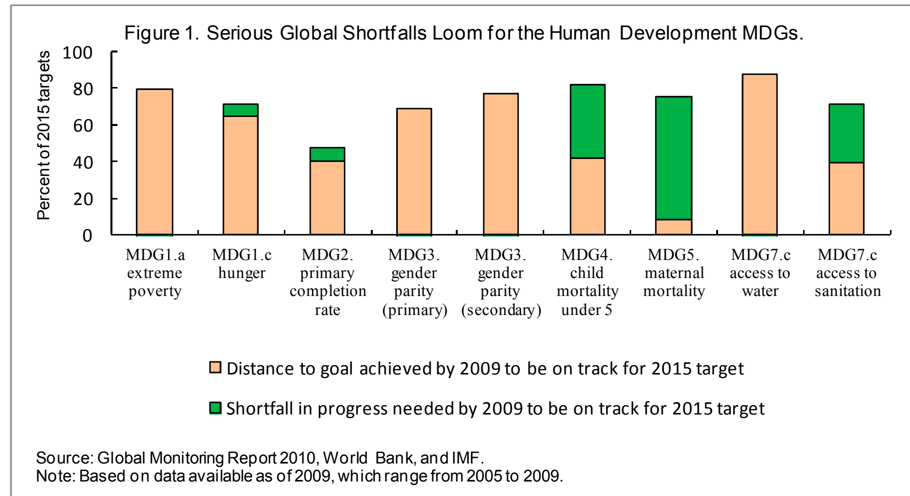
I. Introduction

1. **Prior to the crisis, many developing countries had made considerable progress in reducing extreme poverty, thanks to an extended period of strong economic growth**. Poverty had fallen by 40 percent since 1990, and the developing world as a whole was well on track to reach the global target of cutting income poverty in half by 2015. Thanks to rapid growth, especially in China, East Asia had already halved extreme poverty. Although Sub-Saharan Africa (SSA) as a whole was unlikely to reach the target, poverty had also been falling rapidly there since the late 1990s (World Bank and IMF, 2010). Progress on the other Millennium Development Goals (MDGs), however, was uneven across the indicators and regions (Figure 1).

Figure 1. Serious Global Shortfalls Loom for the Human Development MDGs.



Source: Global Monitoring Report 2010, World Bank, and IMF.
Note: Based on data available as of 2009, which range from 2005 to 2009.

2. **The crisis has set back progress toward the MDGs**. Poverty rates will continue to fall after the crisis, but more slowly, as the recovery will not make up all the lost ground. As a result of the crisis, illustrative estimates from growth analysis suggest that 71 million fewer people will have escaped poverty by 2020 (World Bank and IMF, 2010). The impact on other MDGs may also be considerable: an additional 1.2 million children might die before age five between 2009 and 2015, and 100 million more people might remain without access to safe water in 2015.

3. **Boosting growth in developing countries is not the only remedy needed to regain momentum toward the MDGs, but it is a necessary condition**. The macroeconomic policy requirements to ensure strong and sustainable growth in low-income countries (LICs) will be the focus of this paper. Clearly, while necessary, these are not sufficient to achieve the MDGs. Growth must be pro-poor, including through growth patterns that benefit the areas and sectors where the poor are the most numerous; and reaching the other MDGs also requires a wide-ranging and ambitious agenda of micro and sectoral level efforts to promote access to social services and basic infrastructure.

4. **This paper will focus on several key policy challenges to restore and accelerate growth in LICs, and make growth more resilient to shocks**. It will highlight needed policy actions by both developed and developing countries, and the role of the Fund in helping countries address these challenges:

- First, collective action by advanced and dynamic emerging economies is needed to ensure a restoration of sustained, balanced global growth, which is a precondition for restoring growth in LICs.

- Second, countries need to rebuild policy buffers that served them well during the crisis, so that they can respond pro-actively to future adverse shocks with policies that mitigate the growth costs and protect the most vulnerable groups. And further actions are needed to help LICs build resilience to shocks.

- Third, addressing the critical bottleneck to accelerating growth in LICs posed by the massive infrastructure deficit will require both a new financing agenda and a strengthening of capacities and policies to ensure that scaled-up investment generates growth while maintaining debt sustainability.

- Fourth, opening markets to create more opportunities for these countries to expand trade will further strengthen the ties between a dynamic global economy and growth in LICs.

- Finally, more effective engagement by the international community in countries in fragile situations is needed to ensure that these countries are not left behind in the pursuit toward the MDGs.

5. **The Fund is assisting countries meet the crisis and post-crisis challenges.** As the crisis broke, the Fund responded swiftly and forcefully with scaled up financial assistance to support countercyclical policies. The design of Fund-supported programs was adapted accordingly, with streamlined and more flexible conditionality. Access limits for loans were doubled, the overall scale of lending to LICs was quadrupled, and interest payments on all concessional loans were waived through end-2011. A new allocation of Special Drawing Rights (SDRs) boosted developing countries official reserves by US$100 billion. Emphasis in programs on social safety nets aimed at lessening the impact of the crisis on vulnerable groups. At the same time, the Fund reformed its own lending instruments to better reflect the diversity of LICs' needs, providing more flexible options to countries in support of their macroeconomic stability, growth and poverty reduction objectives, and helping them better to address future shocks.

Box 1. A Macroeconomic Policy Agenda in Pursuit of the MDGs

Strong policy actions are needed to secure rapid, sustainable growth in LICs—a prerequisite for regaining momentum on poverty reduction and the MDGs:

Advanced and major emerging economies should:

- Take further actions to safeguard the global recovery, including addressing fiscal sustainability and progress toward financial system repair and reform.
- Make trade a powerful engine of development, by taking actions to conclude the Doha Round, improve trade preferences, and implement complementary measures to support poor countries' own trade promotion and reform efforts.
- Meet aid commitments, even in the face of tight fiscal constraints; support capacity building for safe and effective scaling up of investment.
- Together with multilateral development banks, explore ways to foster development of contingent financial instruments, including insurance.
- Give greater priority in financial and technical assistance to fragile states, and strengthen the coordination of this support.

Low-income countries should:

- Rebuild policy buffers that proved effective in the global crisis and will be needed to deal with future shocks. Timing and extent of fiscal adjustment will be country specific, preserving or increasing real spending, including for social programs, where there is space.
- Strengthen other shock absorbers, including by deepening domestic financial systems and developing effective social safety nets.
- In scaling up investment to address the "infrastructure gap," strengthen capacity to invest efficiently and borrow safely. Expand financing by mobilizing domestic resources more efficiently and creating the conditions to attract and maximize the growth benefits of FDI.
- Reduce their own high tariff and nontariff barriers, so as to exploit growth-enhancing trade opportunities in regional and global markets.

The IMF will help by:

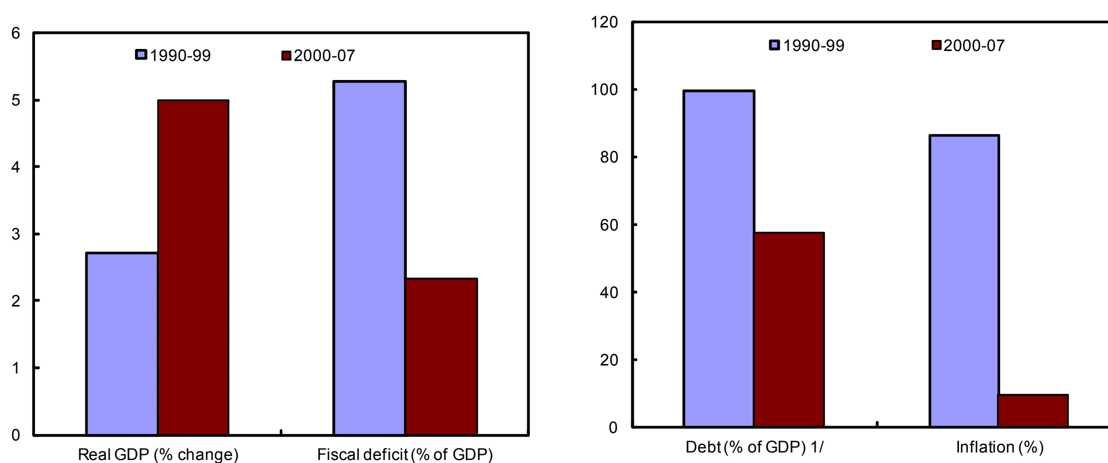
- Using its reformed lending instruments to make available financial support to countries facing shocks and macroeconomic instability, by continuing efforts to streamline conditionality, and maintaining the suspension of all interest payments on concessional loans during the crisis recovery period.
- Providing advice on the macroeconomic policies needed to safeguard the current recovery and rebuild buffers to help address future volatility.
- Assisting low-income countries in developing sound strategies for scaling-up of investment, including advice on better domestic resource mobilization and "safe borrowing."
- Providing technical assistance and support for capacity-building, with a view to strengthening countries' ability to manage resources more effectively in pursuit of their growth and poverty reduction goals.

II. Why This Time Is Different and the Role of the Fund During the Crisis

A. Strong Macroeconomic Policies Underpin Growth and Poverty Reduction

6. **Prudent macroeconomic policies and improved institutions had played an important part in achieving sustained growth prior to the crisis.** In particular, many LICs had strengthened their fiscal and external balances as well as their reserve positions, and had brought inflation down (Figure 2). Further, debt relief, including through the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative, had contributed to a marked decline in debt. Many emerging market economies (EMs) had also strengthened their policies. The favorable external environment, including strong trade growth, favorable terms of trade for many countries, and rising inflows (aid, foreign direct investment, remittances) to developing countries also supported growth.

Figure 2. A Decade of Improving Policies led to a Stronger Pre-Crisis Position in LICs



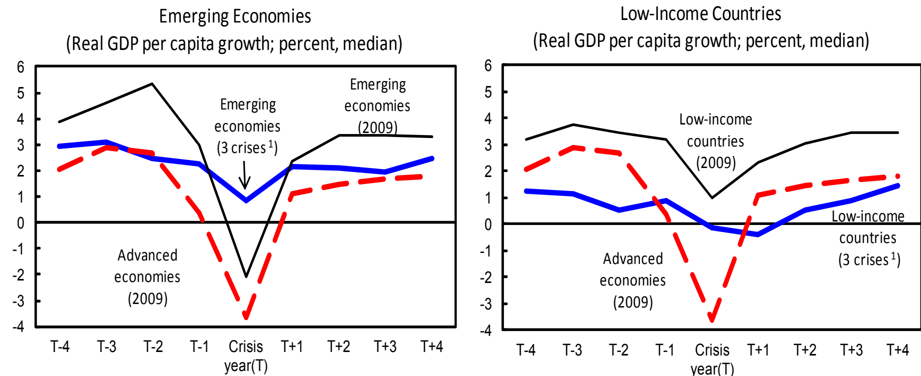
Source: WEO, Fund staff calculations.
1/ For debt ratios, end-of-year averages.

7. **Improved policies not only spurred growth, they also helped build "policy buffers."**[1] When the crisis hit, these buffers allowed many countries to conduct countercyclical policies, successfully limiting the crisis-induced decline in growth. Those countries that had improved their policies most during the pre-crisis period were able to mount the strongest countercyclical responses (IMF, 2009c, 2010a, and 2010b, Yang et. al, 2010). For LICs as a whole, this was the first time they had successfully used countercyclical policies to dampen a crisis.

[1] We use the term "policy buffers" to include low fiscal and current account deficits, higher international reserves, low debt and low inflation. Building these buffers in good times provides countries with the space to conduct countercyclical policies during bad times.

8. **The improved pre-crisis policies and the use of buffers during the crisis give reason to expect that the recovery in developing countries' growth will be faster than in previous crises**. EMs are expected to see growth accelerate to about 3½ percent in 2010 and 4 percent in 2011, while LICs' growth is forecast to rebound to around 4½ percent in 2010 and 5¼ percent in 2011. Thus, while some output was permanently lost in the crisis, both country groups may see growth rates rebound more quickly than in past crises, to levels not far short of their pre-crisis average.[2] The recovery will proceed at different speeds across regions, however, and there are significant downside risks due to uncertain global economic prospects (discussed below).

Figure 3. Low-Income Countries and Emerging Economies: Recovery is Expected to Mirror that of the Advanced Economies



1/ Past global crises years are 1975, 1982, and 1991.
Sources: International Monetary Fund; WEO Database, and IMF staff calculations.

9. **While the crisis has set back progress on the MDGs, the fallout may be smaller than in past crises, so long as the recovery is maintained.** Data on the degree of deterioration in development indicators will not be available for two or more years, and some impacts—for example, on mortality rates and school completion rates—will materialize only after several years. The experience from past crises has been that poverty typically increases significantly and for a long time following a crisis. For example, once children are taken out of school, future human capital is permanently lowered. The relatively speedy recovery in economic growth expected this time around, however, gives some grounds to hope that the crisis impact will be less severe, as does the evidence that poverty-reducing spending has held up better than in the past: indeed, in contrast to past experiences, many countries increased such spending during the crisis rather than cutting it (World Bank and IMF, 2010).

B. How the Fund Has Helped

10. **The IMF has contributed to efforts to meet the MDGs by helping countries achieve and maintain macroeconomic stability, and smooth adjustment to shocks**. Lasting poverty reduction requires sustained growth, which in turn requires macroeconomic stability. The IMF helps countries achieve these goals primarily by providing policy advice,

[2] Berg et. al (2010a) analyze the medium-term implications of the crisis on growth in LICs.

technical assistance, and capacity-building. A large share of technical assistance is in the area of public financial management, which not only promotes macroeconomic stability but also helps countries make better use of resources to achieve their poverty reduction objectives. The IMF also helps countries smooth the adjustment to shocks by providing temporary financial support. Abrupt adjustment, in the absence of such financing, would be unnecessarily costly. Countries that have made extensive use of IMF-supported programs have experienced a marked improvement in long-term economic performance (IMF, 2009a).

11. **The IMF has also worked to ensure that developed countries support developing countries, and to help developing countries make the best use of this support**. The IMF has urged developed countries to pursue policies conducive to strong, sustainable global growth; advocated the opening of markets to help developing countries gain additional export opportunities (see below); and pressed for increased and more effective aid. To help make the case for scaled-up aid, the Fund has in recent years put special emphasis on assisting countries in developing scenarios to assess the macroeconomic consequences of larger aid flows, while stressing the importance of the countries' own policy efforts toward achieving the MDGs (Gupta et. al, 2006, and Berg et. al, 2010b).

12. **The IMF supported developing countries' responses to the global crisis through a substantial scaling up of financial assistance, and by support for countercyclical polices and the protection of social spending**. In 2009 the Fund ramped up its nonconcessional lending commitments (mainly to emerging markets) to US$120 billion (from a pre-crisis level of only US$1.2 billion in 2007), and quadrupled its concessional lending to LICs to almost US$4 billion.[3] IMF-supported programs typically allowed for fiscal accommodation, and LICs that had an IMF-supported program increased fiscal spending by more than those that did not. Most programs began to incorporate a more relaxed fiscal stance in 2008 and 2009 in response to the global food and fuel price shocks and the global financial crisis. Countries with moderate debt levels could afford a stronger fiscal expansion than countries with high debt, demonstrating how past success in macroeconomic stabilization created the needed policy space in many LICs for countercyclical responses (Yang et. al, 2010). The Fund also advocated the protection of social spending during the crisis to avoid unnecessary long-term negative effects that could arise, for example, from the reduction in health and education spending, which would tend to undermine human capital accumulation.[4]

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[3] These amounts are additional to the US$100 billion in additional reserves provided to all developing countries (US$18 billion to LICs) through the new SDR allocations that became effective in August/September 2009.

[4] Based on a sample of LICs with available data, during the crisis most of these countries budgeted preserved or higher social spending in 2009, including countries with Fund-supported programs (Yang et. al, 2010; IMF, 2009c). And preliminary budget outturn numbers for 2009 indicate that health and education spending increased in real terms in 20 of the 29 LICs in SSA (IMF, 2010d).

13. **These increased resources are now being channeled through a reformed set of lending facilities for LICs.** The new facilities provide more flexible financing options that are better tailored to the differing needs of an increasingly diverse set of LICs (IMF, 2009b). Three new financing facilities were created: (i) an Extended Credit Facility to provide flexible medium-term support; (ii) a Standby Credit Facility to address short-term and precautionary needs; and (iii) a Rapid Credit Facility, offering emergency support with limited conditionality. After 2011, when the temporary interest suspension expires, the concessionality of these loans will remain permanently higher than under the previous facilities. The new facilities will continue to place a strong emphasis on poverty alleviation and growth objectives—including, wherever appropriate, specific targets to safeguard social and other spending. Program conditionalities have also been streamlined, and provide countries with more flexibility in achieving their reform goals.[5]

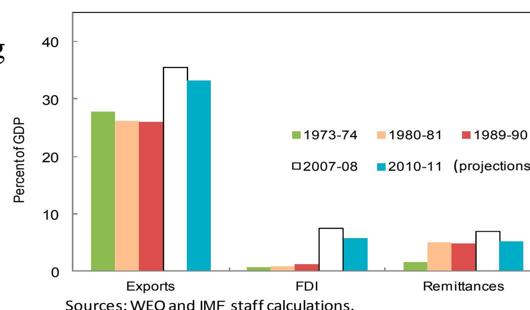
III. Securing Strong and Sustainable Growth: A Policy Agenda

A. Restoring Sustainable Global Growth

14. **Restoration of strong and sustainable global growth is critical to speed up progress towards the MDGs**. Growth prospects in developing countries are heavily dependent on the global economic outlook. Thanks to coordinated fiscal stimulus and monetary easing around the world, global economic recovery has been faster than expected. The rebound in emerging economies, particularly in Asia has been swift and strong, partially compensating the relatively sluggish growth in advanced countries. Nevertheless, risks to the recovery have intensified in recent months, related in part to concerns over sovereign debt burdens in some advanced economies. A potential further intensification of these concerns could slow growth in advanced economies and, given trade and financial linkages, in developing countries as well. In the medium term, there is also a risk that potential growth in advanced economies may be lower as a result of the crisis.

15. **External factors, including prospects for exports, foreign direct investment (FDI) and remittances will influence the pace of growth recovery in LICs.** LICs that have diversified their exports more into large emerging markets are expected to enjoy a stronger pick-up in demand for their exports than countries whose main trading partners are advanced economies. FDI and remittances are also expected to rebound (Figure 4), but probably at a moderate pace in the short to medium term. FDI contracted sharply in 2009, and with the corporate sector in advanced countries continuing

Figure 4. Recovery will Depend on the External Environment



Sources: WEO and IMF staff calculations.

[5] In particular, the use of binding conditions on structural reforms has been abolished in all Fund arrangements. Such reforms are now monitored in the context of broad-based program reviews that put more focus on outcomes.

to consolidate its balance sheets in the wake of the crisis, the recovery of FDI in LICs is likely to be a slow process. Overall remittances declined in 2009 for the first time in decades. The World Bank forecasts that remittances will grow again in 2010-11, at an annual rate of 6-7 percent (Ratha et. al, 2010). However, given the slow growth in job creation and the depressed housing markets and construction industry in advanced countries, it is unlikely that remittances will resume the extraordinary pace of growth prior to the crisis.

16. **The strong trade and financial links between developing and developed countries highlight the collective responsibilities of major economies for restoring global growth.** The nature of the downside risks points to certain priorities for policy in the period ahead. Policymakers need to strike a delicate balance between maintaining short-term economic support to strengthen recovery, and medium-term fiscal consolidation to reinforce economic fundamentals and rebuild buffers. This balancing act is particularly challenging in advanced countries given their elevated public debt levels. Against this background, IMF staff has advocated differentiated policy actions, recognizing that countries have been recovering at different speeds and are in different positions:

- Urgent action is needed to restore policy confidence and address fiscal sustainability, particularly in advanced countries facing large fiscal deficits. Fast-growing advanced and emerging economies can start tightening policies now. Countries currently facing difficulties in funding their deficits will have to take upfront measures, or market pressures may force some of them to make a rapid and difficult adjustment.
- Monetary conditions should remain supportive, given low inflation and well-anchored inflation expectations. Liquidity support for financial institutions should be continued, given the current problems in funding markets.
- Faster progress toward financial system repair and reform is essential. Regulatory uncertainty needs to be reduced and banking systems made more robust to shocks. Other structural reforms to enhance medium-term growth and competitiveness are also needed, particularly in advanced economies.
- In emerging economies with strong current account positions, policy should aim at expanding domestic demand, supported by greater exchange rate flexibility to facilitate a rebalancing of demand towards domestic sources.

17. **These policies would lead to stronger, more balanced and thus more sustainable global growth**. If implemented consistently by the world's major economies (advanced and emerging), Fund staff analysis suggests that the actions outlined above would lift global GDP growth by up to 2½ percentage points over the medium term (on a cumulative basis), compared to existing policy plans, while global imbalances would narrow appreciably. Employment gains would also be significant across regions, with global employment expanding by an estimated 30 million jobs. According to the World Bank, these collective policy actions would lift an estimated 33 million people out of poverty worldwide (IMF, 2010e, World Bank, 2010c).

B. Building Resilience to Shocks

18. **External shocks can be extremely costly for growth and the MDGs.** Developing countries, especially LICs, typically face large external shocks—natural disasters, commodity price fluctuations, and volatility in financial flows (including aid instability). At the same time, they have weak "shock absorbers." This partly reflects shallow domestic financial markets and weak links to global financial markets that make risk diversification difficult (Loayza et. al, 2007). Social protection systems that could act as automatic stabilizers are also absent or not well developed. Further, LICs are "under-insured" against shocks relative to other countries. Self-insurance, for example, by building large reserve buffers, has particularly high opportunity costs for LICs, given their critical investment needs. And market-based instruments are expensive or generally unavailable for LICs. Weak shock absorbers and underinsurance tend to amplify and lengthen the economic impact of shocks, and as a result, LICs suffer substantial growth and welfare losses from macroeconomic volatility.

19. **In order to withstand future volatility, countries should start rebuilding their policy buffers as the recovery takes hold.** Buffers that had been built prior to the crisis have been partially depleted as a result of countercyclical policies. Fiscal deficits have widened and LICs' external debt has risen by about 7 percent of GDP (IMF, 2010c). A key question will be how fast to readjust policies. Policymakers will have to balance the competing demands of preserving growth during the recovery while rebuilding buffers at a sufficiently fast pace to be prepared for future volatility. Countries with stronger pre-crisis policies and buffers will find the adjustment easier than others, because they suffered smaller output losses.[6]

20. **Rebuilding policy buffers and accelerating progress toward the MDGs are consistent objectives**. Rebuilding buffers is critical to minimize future disruptions to sustained growth that is vital to reaching the MDGs. Resilient growth is essential for improving living standards and generating resources to facilitate sustainable increases in social spending over the longer term.[7] In strengthening their fiscal positions, countries should focus on improving domestic resource mobilization, while protecting spending on the core MDG-related programs.

21. **In addition to strengthening macroeconomic policy buffers, there is scope for developing countries to enhance their built-in shock absorbers and make greater use of "insurance" instruments to manage future volatility.** Developing countries themselves, the international financial institutions, donors, and the private sector all have a role to play:

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[6] There is preliminary evidence that LICs with higher initial buffers could afford to raise spending more, and that countercyclical fiscal policy helped reduce the impact of the crisis on growth and protected core spending (IMF, 2010a).

[7] Human development indicators tend to worsen much more in bad times than they improve in good times (World Bank and IMF, 2010).

- **Strengthening shock absorbers in LICs.** Building social safety nets requires strengthening capacity for better targeting of social benefits to the most vulnerable, and improving the efficiency of social spending. Work in this area should be given high priority, so that countries are better prepared when the next crisis hits. Deepening domestic financial systems can also help, by enabling households and firms to smooth consumption and investment more effectively. Policy advice from the Fund, the World Bank, and donors, as well as technical assistance to help build the institutions that underpin policies, can assist countries in enhancing these shock absorbers**.**

- **Developing *ex ante* insurance options.** To expand opportunities for countries to obtain *ex ante* insurance (in addition to *ex-post* assistance through borrowing), the international community could help develop markets for suitable insurance instruments; create contingent financial instruments, such as terms-of-trade indexed debt and GDP-linked bonds; and allow contingent repayment of official borrowing. Types of contingent official assistance could include loan contracts with options for deferred repayments in the event of pre-specified events (for example, the Agence Française de Développement offers a loan on which the borrower can defer repayments when there is an adverse export shock), or loan contracts that provide for reduced debt payments in bad times and increased payments in good times.[8]

22. **Dealing with the enormous challenge posed by climate change will be a critical part of building resilience to shocks.** The pervasive impacts of climate change are already being felt—rising sea levels, and more droughts, floods, strong storms, and heat waves. These adverse changes disproportionately affect developing countries and inadequate infrastructure makes them more vulnerable to climate-related extreme events. Mitigation and adaptation to climate change in developing countries will require large amounts of new resources and this will compete with other development priorities. Developed countries will need to provide substantial financial assistance to developing countries, and much of this assistance will need to be on concessional terms to ensure debt sustainability in LICs. Given the difficult fiscal situations in many advanced countries over the short to medium term, innovative financing schemes are called for (Bredenkamp and Pattillo, 2010).

C. Scaling Up Investment for Growth

23. **Much higher investment in LICs is critical to achieve accelerated and sustainable growth that will help reduce poverty, and to enable LICs to compete more effectively in global markets**. There is broad consensus that many LICs, particularly in

[8] In addition to helping countries manage volatility through more comprehensive risk management strategies, the development of effective and affordable insurance-type instruments could also help reduce needs for self-insurance in the form of high international reserves, which (as noted) have high opportunity costs in LICs given critical needs for infrastructure investment and development spending. Adequate reserve levels, however, are important in buffering shocks.

SSA, face a massive infrastructure deficit (Commission on Growth and Development, 2008). The cost of addressing SSA's infrastructure needs is estimated at around US$93 billion a year, equivalent to 15 percent of the region's GDP, or 22 percent of GDP for the region's LICs (Briceño-Garmendia et. al, 2008). Increased infrastructure spending, especially in transportation and power generation, can play an important role in stimulating sectors vital to growth, facilitate structural transformation, and promote regional and international trade (Ndulu et. al, 2007, and World Bank, 2007). In addition to spurring and enhancing the productivity of private investment, some types of infrastructure also have direct links to the MDGs. For example, closing infrastructure gaps will increase access to safe water and sanitation and contribute to improved health indicators (Agénor and Moreno-Dodson, 2006).[9]

24. **Meeting these massive investment needs requires a push for "financing for development" from several different sources:**

- Clearly, there is a continuing need for large scale, highly *concessional finance* for investment financing from donors. Meeting aid commitments needs to remain a priority for donors, even as they are facing tight fiscal constraints. Those constraints, in turn, further underscore the importance of enhancing the overall effectiveness of aid. Similarly, donors could do more to align their support with the priorities of LICs, to ensure the appropriate balance between funding the social and human development programs associated with the MDGs, and financing investment for future growth.
- Strengthened *domestic resource mobilization* should also play an important role in sustainable development financing. There is significant scope for increasing the tax efforts aimed at enhancing development spending. In SSA, for example, average tax revenues amounted to about 17 percent of GDP in 2007, compared to about 23 percent for upper middle-income countries.
- More infrastructure, good policies and a supportive business environment will help attract *FDI*, an important financing source for private investment (Dabla-Norris et. al, 2010). Public-private partnerships, in sound institutional frameworks that minimize fiscal risks, as well as *innovative financing* (for example, sovereign wealth fund investments, diaspora bonds, risk mitigation guarantees by multilateral development banks), may also be considered in some countries.
- For resource-rich countries, a more effective harnessing and management of *natural resource revenues* could be a key element of their investment, growth, and poverty reduction strategies. Governments need to secure an appropriate share of the rents from resource extraction, while ensuring adequate incentives for exploration and production, and then improve the deployment of these resources through sound and transparent fiscal frameworks and institutions (Daniel, Keen, and McPherson, 2010).

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[9] Better transportation networks will also contribute to easier access to health care, particularly in rural areas (Wagstaff and Claeson, 2004). The complementarity effect of infrastructure on private investment and its productivity in developing countries has been well documented in the literature (Agénor, 2004).

- With concessional finance in short supply, some LICs—those that have sufficiently strong public finance and debt management institutions, and low debt vulnerabilities— could be in a position to utilize effectively some *nonconcessional borrowing*, including from market sources.

25. **LICs that resort to debt-financed investment need to strengthen their capacity for "safe borrowing"—so that the scaling up of public investment does not jeopardize debt sustainability**. Borrowing decisions must be made within the framework of a sound debt management strategy and a well-planned public investment management process that increases the likelihood of high returns from selected projects, so that the borrowing does not impose undue risks to debt sustainability (and, hence, the country's growth strategy) over the longer term. The impact of public investment on growth depends on the institutional context in which investment decisions are made, the quality of project evaluation, selection and management, and the regulatory and operational framework (IMF and World Bank, 2009). Building the capacity to identify, assess, implement and monitor projects, supported by transparent and accountable processes (in short, "good governance") is key. Economic and institutional indicators that measure these capacities can help guide the assessment of the scope to increase productive public investment and its growth benefits. To ensure repayment for public debt-financed investment, LIC governments must also have the capacity to capture the fiscal dividends, which depends primarily on the quality of revenue policy and administration.

26. **Mindful of the very large investment needs faced by LICs and the improving economic fundamentals in a number of countries, the Fund recently adopted a more flexible policy on debt limits in IMF-supported programs**. The new approach reflects better the diversity of LICs and their financing patterns, and offers more flexibility case-by-case, depending on individual countries' debt vulnerabilities and public financial management capacity (IMF, 2009d).[10] The Fund, together with the World Bank, is working on tools to help countries assess these capacities, including the strength of the public investment management process, and to identify priorities for upgrading. Further analytical work is also underway on macro-frameworks for analyzing the growth impact of debt-financed investment. Together, with the World Bank and other development partners, the Fund is also helping LICs build capacity in a broad range of relevant areas, including the macroeconomic management of aid inflows, public finance management, debt management, tax policy and administration, and fiscal frameworks and institutions in natural resource economies.[11] More investment financing and the capacity for top-quality utilization of the resources need to go hand-in-hand.

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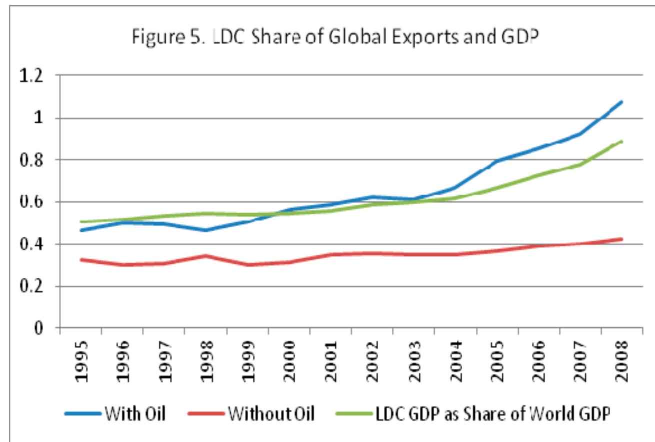
[10] A number of SSA countries have already benefitted from the increased flexibility, and have space in their IMF-supported programs to contract significant nonconcessional borrowing (e.g., Mozambique, Rwanda, Tanzania, and Uganda).

[11] With support from donors, the Fund is scaling up its capacity building, notably through its regional technical assistance centers and multi-donor topical trust funds. Two new technical assistance centers are being planned

(continued)

D. Expanding Trade for the Poorest Countries

27. **Trade is an engine of development and can contribute strongly to reducing poverty.** Yet, due to access barriers abroad and obstacles at home, exports of the poorest countries are far below potential. These "least-developed countries" (LDCs) account for under ½ percent of global non-oil exports—a figure that has been nearly static, in contrast to the dynamic trade growth of other developing countries (Figure 5).[12] This structural problem has become more urgent as the crisis has led to reduced LDC exports.



28. **Perhaps the single most important step that the international community can take to support the exports of LDCs—and, indeed, of all LICs—is to conclude the WTO Doha Round.** Broad multilateral trade reforms would foster global trade and growth and a global macroeconomic environment conducive to development. Moreover, tighter trade commitments would bring enhanced security to the rules-based trading system, helping these small and often vulnerable economies to attract quality long-term investment.

29. **More and better trade preferences, along with several complementary actions to support LDC exports, should also be pursued vigorously**. Prompted by the 2000 UN Millennium Declaration and the 2005 WTO Hong Kong Ministerial Declaration, some countries have enhanced their trade preferences for LDCs. But advanced and major EM countries can do more. Model estimates suggest that expanding the coverage of trade preferences could alone lead to increased annual LDC exports of some US$10 billion (about 2 percent of LDC GDP), with other proposed reforms of preference schemes multiplying these benefits. Complementary steps by the international community are also needed to cut

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for Africa, and trust funds on Tax Policy and Administration and Managing Natural Resource Wealth are expected to become operational in 2011.

[12] In this section, we refer specifically to LDCs, since this grouping is widely used in the WTO context. As classified by the United Nations, there are currently 49 LDCs, who are a subset of LICs, identified according to criteria such as per capita GDP and structural impediments to growth.

distortions in world agricultural markets, help LDCs to meet product standards, and to provide more effective Aid for Trade. These "themes" translate into several specific "actions" to support LDC trade (Box 2). [13]

Box 2. Key Actions to Support LDC Exports

- **Advanced market countries (AMs) could give full duty-free quota-free market access (DFQF) to LDCs**. Product exclusions—even if a few percent of tariff lines—target key LDC exports, and in some schemes country exclusions sharply limit overall LDC benefits. Full DFQF by AMs could raise annual LDC exports by US$2.1 billion. AMs could also tilt benefits toward LDCs, with clear preference graduation provisions for the more advanced developing countries.
- **Major emerging markets (EMs) could provide full DFQF over time.** Major EMs account for a third of LDC exports and are growing rapidly. With higher tariffs and narrower preference coverage at present, full DFQF provision by EMs could raise annual LDC exports by US$7.7 billion.
- **AMs and EMs could simplify and ease rules of origin (RoO).** Preferences are utilized on only some 2/3 of eligible trade, and much less for textiles and clothing. Overly restrictive RoO discourage sourcing inputs from the cheapest suppliers, pose administrative costs (about 3 percent of the price), and in extreme cases may cut benefits by 75 percent. Working with the LDCs, preference providers should harmonize RoO so that an LDC product can be effectively marketed to various preference providers.
- **Preference providers could broaden cumulation rules to allow inputs from all LDCs and LICs.** Disallowing preferences because inputs are sourced from other LDCs or LICs cuts benefits and inhibits South-South trade. Allowing LDCs to source inputs more broadly would increase preference utilization and help LICs to share in the benefits of LDC preferences.
- **LDC exporters could be granted equal opportunity in government procurement.** Most AM and EM governments discriminate—some heavily—against foreign suppliers in public procurement. LDC exporters should be accorded the same treatment as local suppliers.
- **Distortions in global agricultural markets should be addressed.** Many LDCs have a comparative advantage in agriculture, but policies abroad (and at home) depress market prices and make them more volatile, and discourage investment. Investments are needed to increase LDC food output, together with transitional measures for LDCs that are currently net food importers.
- **LDCs could be helped to meet product standards.** Complex product standards can pose major obstacles for LDCs. AMs and EMs can help by adopting international standards and by expanding financial or technical assistance to build LDCs' capacity to meet standards and to participate actively in international standards setting bodies. For example, the Standards and Trade Development Facility helps developing countries comply with sanitary and phyto sanitary measures.
- **Key gaps in Aid for Trade (AfT) could be filled.** Aid to infrastructure projects is helping to build LDC trade capacity, but other AfT areas merit more attention. Transport and communications services—areas critical to trade—are often costly and unresponsive to evolving needs; support for policy reforms can enhance overall competitiveness. And support for regional cooperation—policy, institutions, and infrastructure—has proven difficult to coordinate and deliver effectively.

[13] The actions draw on an IMF staff position note (Elborgh-Woytek, Gregory, and McDonald, 2010). Most reflect similar proposals by, for instance, the Center for Global Development Working Group on Global Trade Preference Reform or the LDCs themselves. Some related actions are included in the Doha negotiations.

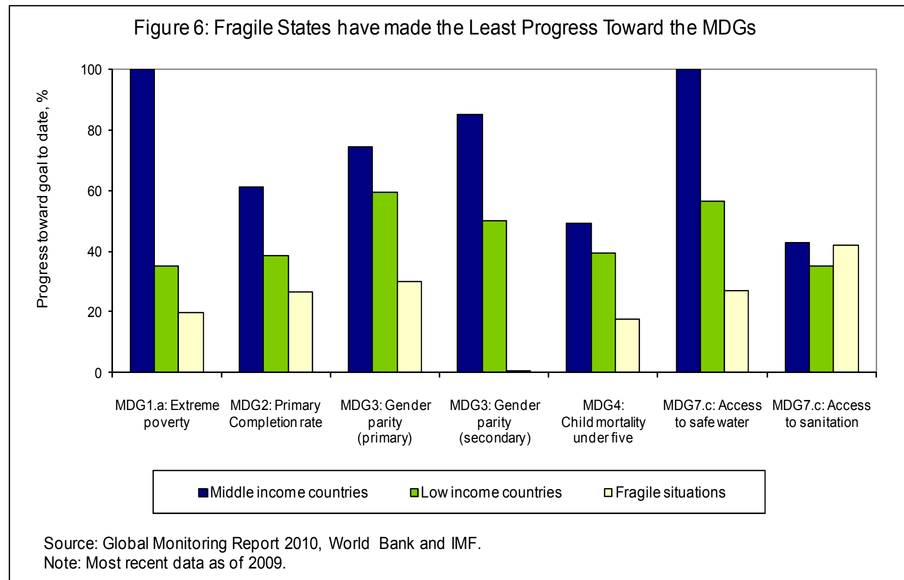
30. **Many of the actions highlighted here would also benefit non-LDC LICs.** Allowing LDCs to source inputs from non-LDC LICs while remaining eligible for trade preferences would allow other LICs to share in the benefits. Cuts in domestic farm subsidies by AMs and EMs would also help non-LDC LICs, and many Aid for Trade programs and initiatives to help countries meet product standards are aimed not only at LDCs but at all LICs.

31. **To benefit strongly from better trade opportunities, the LDCs would need to tackle aggressively their own high tariff and nontariff barriers to trade.** By restricting imports, these barriers effectively tax exports and hamper LDCs' ability to gain from existing and future export opportunities. On tariffs, a reasonable goal within a few years is for a maximum 25 percent rate and a simple average below 15 percent. Nontariff barriers, such as non-critical road blocks and checkpoints, and overly burdensome customs practices, significantly slow trade and should be removed. Service sector reforms would help by cutting costs of key inputs such as transport and communications.

E. Helping Fragile States

32. **Despite significant progress on the MDGs in many countries, fragile states risk being left behind, with serious implications for their populations, as well as risks to peace and security.** Around 600 million people live in countries affected by fragility and conflict (World Bank, 2010b). Poverty rates average 54 percent in these countries, compared with 22 percent for LICs as a whole.[14] Fragile states were already the most off-track to meet the MDGs prior to the crisis (Figure 6). The cumulative effects of the global food and fuel shocks and financial crisis have added to the challenge of achieving the MDGs in fragile states. Continued low incomes, slow growth and poor living conditions in these countries may increase risks of

Figure 6: Fragile States have made the Least Progress Toward the MDGs



Source: Global Monitoring Report 2010, World Bank and IMF.
Note: Most recent data as of 2009.

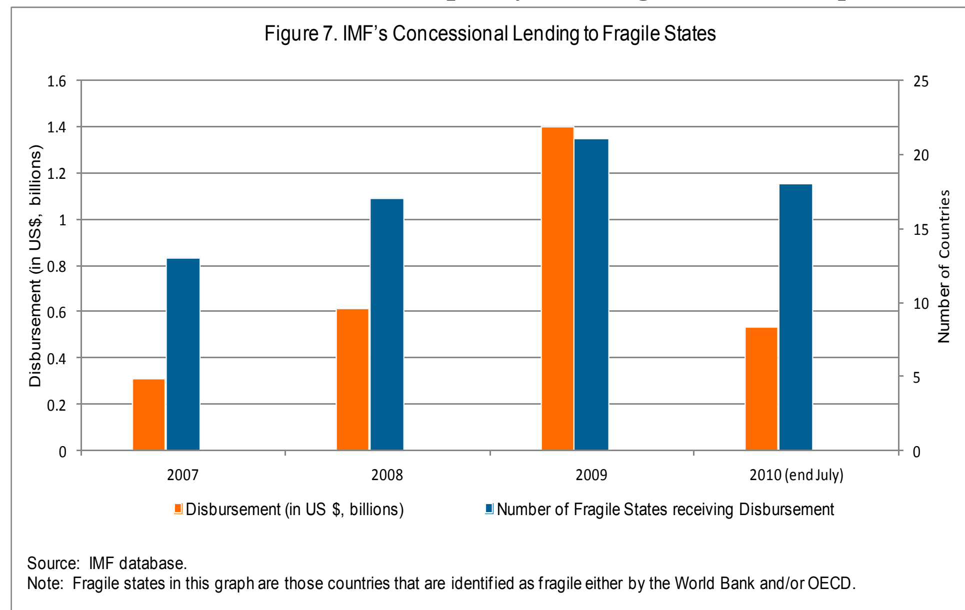
[14] This section generally uses the World Bank's definition of fragile states (which includes 36 LICs and 3 non-LICs), unless otherwise noted. Other definitions can imply that there are up to 1 billion people in such countries.

political instability, or even conflicts, which further undermine economic development and can have negative spillovers to neighboring countries.[15]

33. **Breaking free from conflict and fragility traps is clearly a complex and difficult process.** Economic performance and social conditions in fragile countries are substantially impaired by their weak governance, limited administrative capacity, persistent social tensions, and a tendency to political instability and conflict. These features, associated also with macroeconomic instability and stagnant growth, characterize the "bad" equilibria in which fragile states are often caught. Civil conflicts—"development in reverse"—have the damaging legacy of increasing the risk of repeated conflicts, partly because of the destruction of institutions, locking countries in conflict traps (Collier, 2007). While the challenges are profound, some countries have made successful and sustained transitions out of these fragile situations. A critical part of the process is rebuilding core institutions for economic management so that countries can develop sound policies that have been shown to help sustain a growth recovery.

34. **Learning from this experience, the Fund has been engaged in fragile states through policy advice, financial assistance, and capacity building.** The Fund helps rebuild or strengthen core state institutions and economic management, including fiscal and financial sector/monetary operations that enable countries to develop and implement sound macroeconomic frameworks (IMF, 2008).

Figure 7. IMF's Concessional Lending to Fragile States



Source: IMF database.
Note: Fragile states in this graph are those countries that are identified as fragile either by the World Bank and/or OECD.

The Fund's financial support can also play a catalytic role in attracting aid flows (Gupta et. al, 2006). In addition, the Fund provides policy advice on fiscal, monetary, exchange rate, and financial issues; help in identifying gaps in the related institutional and legal frameworks; technical assistance to follow up on much of this advice; and support for good governance in post-conflict states. During the recent crises the Fund more than doubled commitments under its concessional facilities to fragile states, with its policy advice aimed

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[15] Weak economic conditions, such as low income and slow economic growth, and higher dependence on natural resources increase the risk that LICs fall into civil conflicts. In particular, conflicts often start following growth collapses (Collier et. al, 2009).

at minimizing the disruptions to economic activity and protecting social spending (Figure 7). As part of the reform of the Fund's concessional lending architecture, a new lending window was introduced—the Rapid Credit Facility—that can be used by countries in a wider range of fragile situations than was the case in the past.

35. **Despite efforts made by the international community, there remains a pronounced disparity in aid directed to fragile states.** Development assistance to the 43 countries classified as fragile by the OECD has been growing more slowly than overall aid (OECD, 2010). Moreover, more than half of all aid to fragile states goes to just six countries: many of the others are "aid orphans" in the sense that, on various metrics, they get proportionately less aid than other developing countries. Aid to fragile states is also more volatile over time, less dependable, and more fragmented (with numerous donors, each providing small amounts). Similarly, according to the World Bank classification, per capita IDA flows to non-fragile states were 50 percent higher than to fragile states during 1997-2006 (Boyce and Forman, 2010). While weak capacity to absorb aid in fragile states is clearly a factor, there are lessons on successful timing and types of aid (particularly technical assistance) that could be built on (Collier and Hoeffler, 2004).

36. **Looking ahead, intensified efforts will be required by the international community to meet the challenges in fragile states.** The transition from fragility takes time and the donor community will have to stay engaged over the long term, including by increasing the provision of financial resources and technical assistance for much-needed capacity building. There is also now broad recognition of the links between the political, security and development objectives in fragile states, which highlights the importance of donors working collectively. To this end, the international community has launched a number of initiatives to strengthen cooperation, and it is imperative that these be implemented vigorously. The Fund, for its part, is currently launching a review of its engagement in countries in fragile situations with a view to understanding better the particular macroeconomic challenges faced by such states, and how it can improve its effectiveness—in collaboration with other partners—in supporting transitions out of fragile situations.

IV. Conclusion

37. **To regain momentum in achieving the MDGs, a broad range of policy actions will be required.** The same spirit of global collaboration that was an important part of the international community's successful response to the crisis will be needed in addressing the current development challenges. The IMF was instrumental in advocating and implementing the global crisis response, and has an important role to play in meeting the new challenges ahead. This paper has outlined a number of policy priorities in the macroeconomic area, and has stressed that both developed and developing countries—as well as the multilateral institutions—will need to play their part.

38. **These policy priorities are aimed at restoring and accelerating growth, with a particular focus on LICs, and making future growth more resilient to shocks—all**

critical to rapid poverty reduction and reaching the MDGs. The most immediate step is restoring strong and sustainable global economic growth, which is a precondition for restoring growth in LICs. Scaled-up investment is also needed, to help relieve critical bottlenecks and facilitate accelerating medium-term growth. Aid commitments should be fulfilled, and the poorer countries should be helped to take advantage of greater opportunities for trade. To make growth more resilient, the short-term priority for LICs is a rebuilding of policy buffers to be prepared for future shocks, and to ensure a foundation for sustainable increases in social spending. These efforts should be supplemented—before the next crisis hits—by measures to strengthen the design of safety nets and other built-in shock absorbers, and the scope to complement concessional assistance with development of ex-ante insurance instruments should be actively explored. Finally, fragile states face special challenges, and intensified international collaboration is needed to make progress on building institutions, raising growth, and the MDGs to move these countries toward virtuous circles of development, peace and security.

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