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Development of low-income countries paints a mixed picture

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The current discussion surrounding the state of the global economy is centred around the advanced economies and the emerging markets, with the poorer developing countries not being factored in. It is true that low-income countries (LICs) have little impact on the global economy, and are also not where the major risk factors are to be found. At the same time, the progress made by LICs is worthy of respect. On the one hand, they have seen encouraging, noticeable improvements in important economic indicators. However, this by no means indicates that everything is on the right track. Some figures appear better than they actually are, and the LICs still have considerable deficits with respect to their development that will require determined action.

For the purposes of this analysis, *low-income countries* (LICs) are the 34 developing countries with per capita income of no more than USD 1,045, in line with the World Bank's classification.[1] Twenty six of these countries are in Sub-Saharan Africa, seven are in Asia and one is in Latin America.[2]

Impressive economic growth since the start of the new millennium[3]

For a long time the LICs were only able to achieve very modest GDP growth. The two or three decades leading up to the year 2000 were marked by widespread mismanagement, overindebtedness etc. to the extent that these would have to be referred to as "lost years". Since then, however, the LICs have staged an impressive comeback. As figure 1 shows, the LICs have all reported stronger growth than the industrialised countries since 2001. While they were unable to keep pace with the boom experienced by the emerging markets [4] prior to the global crisis of 2008/2009, they also emerged from the crisis in much better shape. The 6.5% p. a. rate of growth experienced by the LICs since 2011 is significantly higher than in the advanced economies and the emerging markets.

Other macroeconomic indicators have also improved but do not point to a genuinely positive trend

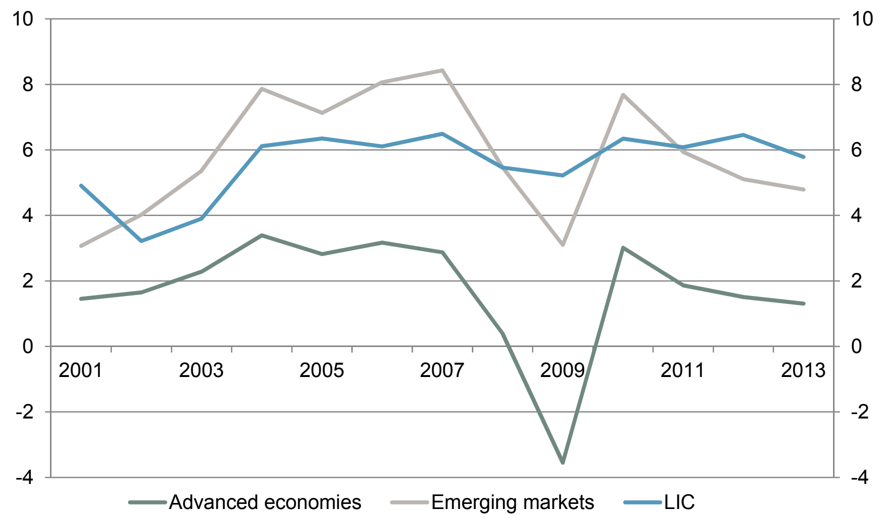
Many external and internal indicators seem impressive at first glance. However, these are put into perspective upon closer inspection, for example if an even stronger trend could really have been expected or other (sub-) indicators point to the continued existence of larger problems.

a) International trade

While LICs' **exports** account for a mere 23% of their GDP (the same figure for emerging markets is 29%), the sustained economic boom in advanced economies and the emerging markets has also significantly boosted growth in LICs. The volume of LICs' exports rose 150% (nominally in USD) between 2005 and 2012. Of the goods exported by LICs, 28% are agricultural products and a further 11% are fuels and mining products. The prices for these goods on the global market have undergone strong positive trends since the start of the new millennium (see figure 2). This market trend not only benefits the LICs with respect to the prices, but also in terms of volumes. China's appetite for commodities has caused LICs' exports to this one booming country alone to surge by a factor of 38 since the year 2000. As a result, China's significance as an export destination rose as its share of all goods exported by LICs rose from 1.5 to 12.3%.

Considering this strong increase in exports, you would be forgiven for expecting a noticeable improvement in the **balance of current account** of the LICs. But there has been no such improvement. Only seven countries reported an improved balance of current account in 2013 compared with the year 2000. Thirteen countries even reported a substantial current account deficit (>10% of GDP), and only four reported a surplus. In order to understand these figures, it is useful to take a look at what goes in to the balance of current account. On the one hand, the increase in the volume of

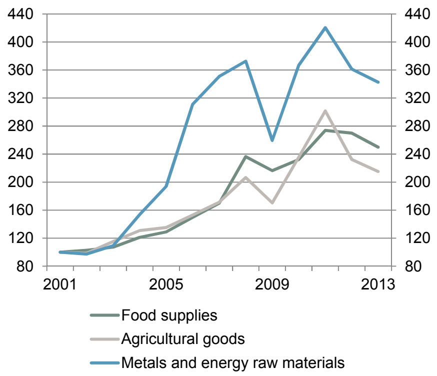
Figure 1: GDP growth compared (real, as per cent)



Source: World Bank.

goods exported by the LICs coincided with an even stronger increase in imports. In other words, the balance of trade actually deteriorated. On the other hand, however, the balance of current accounts of the LICs were also given a partial boost by their net income, which is where interest payments to foreign creditors are recorded, for example. Since the 1970s, many poor, developing countries took out substantial loans for which they were unable to keep up with the repayments, triggering a severe debt crisis. In the post-2000 period looked at here, many LICs were **granted substantial debt relief** in the form of consolidation as well as extensive debt forgiveness.[5] Without this relief, the balances of current account of the LICs would have fared even worse.

Figure 2: Global market prices over time (Index 2001 = 100)



Source: UNCTAD

However, a balance of current account deficit is not necessarily a bad thing in the case of an LIC. For LICs, a deficit (which represents a net import of capital) can by all means be a good thing since capital is a particularly scarce production factor in poor countries and the potential return on capital is therefore high. But the risk of a current account deficit turning from "good" to "problematic" rises as the deficit gets higher. Because their exports are dominated by agricultural goods and raw materials, LICs are at risk of sliding into a balance of payments crisis more rapidly than other countries on account of volatility / uncertainty with respect to volumes and prices.

The debt relief described is also an important factor when it comes to interpreting the **foreign indebtedness** of LICs, which rose from USD 110 billion in the year 2000 to USD 134 billion in 2012. As a percentage of GDP, however, this represents a decline from 72 to 28 %. So while the issue of debt has become much less urgent, it is still on the agenda. The World Bank and the IMF, which monitor the issue closely through regular debt sustainability analyses, currently see a substantial risk of payment problems for eight LICs[6], with one country (Zimbabwe) even already in default. What these countries have in common are a strong focus on a limited number of export goods and / or weak politico-economic institutions, and in a worst case scenario the growth of their debts could lead them once again into a self-reinforcing spiral.

One important indicator when it comes to a country's international trade are its forex reserves. These reserves are a financial buffer to ensure that a country remains solvent at all times. The forex reserves held by LICs rose constantly between 2000 and 2013, from USD 11 billion to USD 67 billion. But despite this increase, forex reserves remain a weakness for LICs. Comparing their forex reserves to their imports shows that the reserves have fallen in relative terms, and in only a few cases cover more than four months of imports. This is not enough considering the potentially significant volatility of LICs' exports (agricultural products and natural resources, see above).

The figures for **foreign direct investment** (FDI) appear surprisingly good at first glance. The volume of FDI received by LICs has risen by a factor of ten since the year 2000, with a figure of USD 24 billion reported for 2012. The volume of FDI received by LICs as a percentage of their GDP rose from 1.4 % in the year 2000 to 4.5 % in 2012, even beating the emerging markets recently. But still, the absolute volume of FDI can be described as modest. Only 1.5 % of all global FDI is received by LICs. By way of comparison: the emerging markets attracted USD 636 billion of FDI in 2012, with China alone receiving twelve times the amount received by all 34 LICs together. So while it is certainly possible to take a positive view of the FDI figures for LICs, the fact is that direct investors give LICs a wide berth.

b) Domestic economy

While production and general employment in LICs are still dominated by agriculture, the manufacturing and services sectors are slowly catching up. The **manufacturing industry** has particularly strong potential with respect to improving productivity and the ability to compete at an international level. The above-average growth of the manufacturing industry in LICs since the year 2000 is therefore to be welcomed. However: the process is slow, and the level achieved (with the manufacturing industry accounting for 12 % of GDP) is still much lower in LICs than in the emerging markets (22 %).

In the past, one hallmark of LICs was their unstable **fiscal policies**. Before 2000, substantial budget deficits and public debt of well over 100 % of GDP were commonplace. This situation initially improved following the start of the new millennium. By about 2006/2007, many LICs had been able to reduce their substantial budget deficits or even generate surpluses, while also reducing their public debts in relation to GDP. But during the global financial crisis of 2008/2009, as the LICs' economic growth faltered, their deficits began to grow again in many cases. Although this may sometimes be due to deliberate fiscal stimuli, in many cases it is likely to reflect weaknesses in fiscal policy, such as a strong reliance on customs duties for public revenue. Unfortunately, the upturn in the LICs' economies in recent years has not seen a return to the earlier progress made with respect to fiscal consolidation. Although public revenues have risen in relation to GDP since the year 2000, the level achieved (often below 20 %, compared with 45 % in Germany) is still too low and all LICs are currently reporting primary deficits in their budgets. All in all, therefore, while the situation with respect to the LICs' budgets has improved, it is still not particularly good.

The same can be said for **inflation** as an indicator. While the times of high double-digit rates of inflation in LICs are long gone (average in 1994: 25 %), inflation is still higher in LICs than in the advanced economies and the emerging markets, and the average figure of 5.5 % for 2013 does in fact conceal some high individual figures of up to 27 % (Malawi). Inflation hits poor people the hardest as they are often unable to compensate for it (low market power) or avoid increased prices, suchas for basic food supplies.

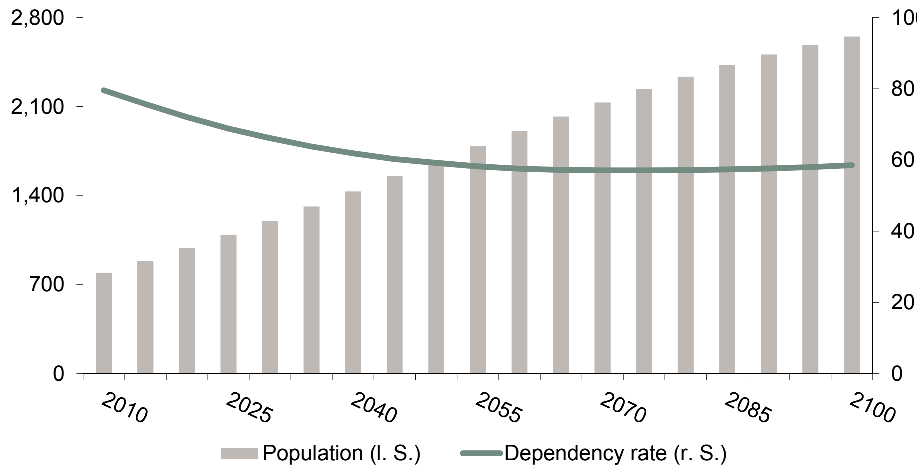
Still a long way to go despite encouraging achievements

As we have shown, LICs have made significant progress with their development in many different areas. Nevertheless, the circumstances in these countries are still unacceptable.

In the year 2000, the international community drafted a catalogue of **Millennium Development Goals (MDGs)**. The key MDG of "halving the rate of poverty between 1990 and 2015" has already been achieved for all emerging markets and developing economies. However, this can mainly be attributed to the emerging markets, and China in particular. In the LICs, on the other hand, the prospect of achieving this goal by 2015 is unrealistic. While it is true that those LICs that benefited from the aforementioned debt relief have been able to substantially increase their poverty related public spending[7], it is nevertheless still the case that almost half of the people living in LICs have incomes that are below the poverty line. The LICs' prospects with respect to the other MDGs are similarly poor, for example in the fields of primary education, health and water supply / waste water disposal. There are also significant deficits with respect to areas of infrastructure not covered by the MDGs (energy, transport etc.).

One reason for this poor performance among LICs with respect to the MDGs is their high rates of **population growth**, which "eat up" any economic growth. Between 2000 and 2010, the population of the LICs grew by a high 25 %, with a further increase of 230 % to 2.7 billion people to be expected by the year 2100 (UN forecast, see figure 3). One point of interest is that this demographic trend by all means has a potentially positive aspect: the "dependency rate" is set to continue falling until around 2070 when it will slowly start to grow again (see figure 3). This figure describes the ratio between young (< 15 years) as well as older people (65+) in relation to those of working age (15–64). While it has been widely

Figure 3: Anticipated population growth (millions) and dependency rate (in per cent) in LICs



Source: United Nations, Population Division, own calculations.

reported that the societies of many advanced economies and emerging markets are already set to age, which is reflected by a rising dependency rate and entails a whole raft of problems, LICs will still enjoy a "demographic bonus" for some time to come. However, this can only be turned into a "demographic dividend" if those of working can actually be given gainful employment – an extreme challenge for LICs in light of the population forecasts and the other major problems they face.

Of the 34 LICs, 18 are classified as **fragile states** by the World Bank. In fragile states, the government does not enjoy a universal monopoly on the use of force, the public administration is weak and citizens do not accept the state's claim to sovereignty (forexample in an authoritarian, single-party state). LICs also score very badly when it comes to the commonly used **governance indicators** (for example the Corruption Perception Index or Ease of Doing Business Index).

Given these poor framework conditions, it is not surprising that only three LICs currently have government bonds on the international capital market (Kenya, Mozambique and Tanzania), although nine of them have been assigned a *sovereign* rating by the big rating agencies. Investors are put off not only by the unfavourable situation at present, but also by the negative past (debt crisis). While it would be entirely inappropriate to talk about unrestricted taking of forex loans for the reasons stated above, the credit financing of economically justified investments is fundamentally also an option for LICs, especially since interest rates on the international capital market are currently extremely favourable.

In any case, **external financing** is extremely important for speeding up the development of LICs. On account of the low levels of income, there is not a single LIC where the rate of saving (S) is higher than the rate of investment (I). The difference between these two indicators is more than 10 percentage points almost across the board, and in some cases even higher than 40 percentage points. In the national accounts, S<I represents a **net import of capital** or a transfer of resources in real terms. In the case of LICs, for which financing via the capital markets barely even enters the equation, as already mentioned, this transfer mainly consists of **official development assistance** (ODA) and **remittances**, as well as **FDI**. Between 2000 and 2012, inflows from these three sources rose steadily from USD 17 billion to USD 91 billion, representing a significant contribution to investment and therefore also to substantial economic growth. While this should really be seen in a positive light, it does also indicate problems in some respects. While ODA financing (soft loans or even grants) is appealing, it is not likely to rise much in the future due to the tight budgets of many donor countries. The high volume of remittances is indicative of the poor situation on the labour markets in the LICs, which forces many people to seek work in other

countries.

Conclusion

In the wider public consciousness, LICs are seen as failed states on account of their poverty as well as reports regarding mismanagement, (civil) wars, natural and humanitarian disasters (currently: Ebola) etc. However, this impression is often inaccurate. LICs have made impressive progress in important areas, including as a result of economic and developmental reforms. Nevertheless, many problems persist, and LICs have highly vulnerable economies. Shocks can quickly wipe out decades of progress. That is why a very cautious and carefully considered economic policy remains absolutely essential. If LICs continue along this path, they will stand a chance of significantly improving their living conditions, and gradually narrowing the gap with more developed countries. Finally, the analysis also showed that LICs are a perfect example of a case where the glass could be described as being either half empty or half full. ■

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[1] There is some confusion arising from the fact that in addition to the World Bank, the IMF also analyses *low-income countries*, but defines them differently. For the IMF, the group comprises 73 countries (fragile states as well as countries with other, particularly challenging framework conditions). The IMF's group is much more heterogeneous than that of the World Bank, which is defined purely on the basis of per capita income. It is also important to remember that the World Bank adjusts the income threshold every year, as a result of which the countries included in the group also change over time. India, Indonesia and Vietnam, for example, are now middle income countries after having been classified as LICs as recently as the year 2000.

[2] Ethiopia, Afghanistan, Bangladesh, Benin, Burkina Faso, Burundi, Eritrea, Gambia, Guinea, Guinea Bissau, Haiti, Kenya, Cambodia, Comoros, Democratic Republic of Congo, Liberia, Madagascar, Malawi, Mali, Mozambique, Myanmar, Nepal, Niger, North Korea, Rwanda, Sierra Leone, Zimbabwe, Somalia, Tajikistan, Tanzania, Togo, Chad, Uganda, Central African Republic.

[3] The data quoted in this paper is based on the comprehensive data compilations of the World Bank, UN, IMF, WTO and UNCTAD. All averages quoted for the group of countries are weighted on the basis of GDP. The availability of data is poor, however, with information often missing for certain countries and/or years, which has made it partly impossible to calculate averages or conduct a detailed chronological analysis.

[4] In this case, "emerging markets" refers to the *middle-income countries* based on the definition used by the World Bank. These countries fall between the LICs and the advanced economies with per-capita income of between USD 1,046 and USD 12,745.

[5] The debt relief provided as part of the *Heavily Indebted Poor Countries* (HIPC) and *Multilateral Debt Relief* initiatives, which benefited 23 of the 34 LICs by providing relief totaling USD 78 billion (nominal), deserves particular mention in this regard. Bilateral creditors also offered substantial debt relief via the Paris Club, as did commercial banks through the London Club.

[6] These countries are Afghanistan, Burundi, Haiti, Comoros, Democratic Republic of Congo, Tajikistan, Chad, Central African Republic.

[7] The debt forgiveness was tied to the condition that efforts to combat poverty would be increased. This is monitored by the donor countries and reported on by the World Bank and the IMF, most recently at the end of 2013.