Africa on the Move

Unlocking the Potential of Small Middle-Income States

EDITORS
Lamin Leigh and Ali Mansoor

INTERNATIONAL MONETARY FUND

Note to Readers

This is an excerpt from *Africa on the Move: Unlocking the Potential of Small Middle-Income States*.

The small middle-income countries in sub-Saharan Africa have delivered impressive economic performance in the past few decades. They have sustained growth while preserving macroeconomic stability. The current challenge for SMICs is how to best consolidate the gains made during the past few decades and move to high-income country and eventually advanced-economy status.

This book analyzes macroeconomic and structural issues facing SMICs from the perspective of IMF staff and draws on input from country officials to offer a number of policy options for addressing these challenges and realizing future opportunities. The areas covered in the book include the macroeconomic vulnerability faced by SMICs and how to enhance their resilience to shocks, an assessment of how labor market outcomes can be improved by reforms that cut spending and crowd in private initiative, structural policies and institutional frameworks that could boost productivity growth in SMICs, and financial inclusion policies that are stability and growth friendly.

Africa on the Move
Unlocking the Potential of Small Middle-Income States
Edited by Lamin Leigh and Ali Mansoor
ISBN: 978-1-51358-860-5
Pub. Date: January 2016
Format: Digital; Paperback, 6 x 9 in., 182 pp.
Price: US$ 30

For additional information on this book, please contact:
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P.O. Box 92780, Washington, DC 20090, U.S.A.
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Contents

Foreword
Antoinette M. Sayeh v

Acknowledgments ix

Contributors xi

1 Introduction ... 1
Lamin Leigh, Ali Mansoor, Friska Parulian, and Andrew Jonelis

2 Macroeconomic Vulnerability: Reserves Adequacy and Fiscal Policy ... 29
Ara Stepanyan

3 Long-Term Implications of Fiscal Policy for Labor Market Outcomes ... 41
Ara Stepanyan

4 Increasing Productivity Growth in Small Middle-Income Countries ... 73
Lamin Leigh, Ara Stepanyan, La-Bhus Fah Jirasavetakul, Andrew Jonelis, Ashwin Moheeput, Aidar Abdychev, Friska Parulian, Martin Petri, and Albert Touna Mama

5 Financial Inclusion and Stability in Africa's Middle-Income Countries ... 107
Yibin Mu and Jenny Lin

6 Political Economy of Reform ... 131
Ali Mansoor

Index ... 161

Foreword

The small middle-income countries (SMICs) in sub-Saharan Africa have delivered impressive economic performance in the past few decades. They have sustained growth while preserving macroeconomic stability. In general, their governments have also effectively addressed those countries' development challenges, including narrowing the infrastructure gap and improving access to education and health. The current challenge for SMICs is how best to consolidate the gains made during the past few decades and move to the high-income level and eventually to advanced economy status.

This book analyzes macroeconomic and structural issues facing SMICs from the perspective of IMF staff and draws on input from country officials to offer a number of policy options for addressing these challenges and realizing future opportunities. The areas covered in the book include the macroeconomic vulnerability faced by SMICs and how to enhance their resilience to shocks, an assessment of how labor market outcomes can be improved by reforms that cut spending and crowd in private initiative, structural policies and institutional frameworks that could boost productivity growth in SMICs, financial inclusion policies that are stability and growth friendly, and finally how political economy constraints could be relaxed to pave the way for gradual but systematic implementation of reforms. The policies discussed in the book lay out a possible road map for the implementation of reforms in all these areas to eventually propel SMICs to advanced economy status.

The findings in each chapter offer specific insights for the convergence process to advanced economy status. Chapter 1 starts by providing an overview of the impressive achievements made by SMICs and their common policy challenges. It compares the SMICs with countries that have succeeded in becoming high income to identify applicable policy lessons and institutional arrangements.

Despite the progress made, evidence suggests that a number of SMICs are facing residual macroeconomic challenges that make them vulnerable to global spillovers. Chapter 2 uses self-insurance models to assess the adequacy of reserves in SMICs. The chapter finds that even though international reserves held by some of the SMICs are broadly adequate to smooth large shocks, other SMICs do not have sufficient reserve buffers to withstand such shocks. Implications are drawn for medium-term fiscal and structural policies in SMICs.

Chapter 3 notes that high unemployment persists in many SMICs despite public employment that contributes to relatively large governments. The analysis shows that high public employment is not only costly but may have a counterproductive impact on labor market outcomes in SMICs. The chapter concludes by assessing how labor market outcomes can be improved by reforms that cut spending and crowd in private initiative.

The book proceeds in Chapter 4 to explore structural policies and institutional frameworks that could boost productivity growth. The analysis shows that the decline in the contribution of total factor productivity (TFP) to growth is largely responsible for the slowdown in trend growth in many SMICs, highlighting the need for policy actions to reinvigorate productivity growth, including by improving the quality of public spending, addressing the skills mismatch in the labor market, reducing the regulatory burden on firms, and facilitating structural transformation in these economies.

The financial sector in SMICs continues to deepen and broaden, with global regulatory reform providing input to national regulatory settings. Although financial deepening is broadly similar to that in other middle-income countries, financial inclusion tends to lag in many SMICs in sub-Saharan Africa. Accordingly, many SMICs are pursuing policies to enhance financial inclusion as part of their efforts toward more inclusive growth. Chapter 5 notes that well-designed, market-conforming programs to enhance financial inclusion could work, especially with input from stakeholders; however, programs to increase access to credit through public sector institutions have so far generally been costly with little sustained impact. Addressing the supply-side and demand-side constraints to lowering intermediation costs and the better pooling of risks would provide a more sustainable basis for enhancing financial inclusion in a stability- and growth-friendly manner.

In view of the main economic challenges in the region, no assessment would be complete without addressing the thorny issue of how to overcome the political economy constraints to reforms in SMICs. Drawing on policy lessons from successful countries that have managed to overcome some of those constraints and moved to advanced economy status, Chapter 6 lays out how political economy constraints could be relaxed by capacity building centered on peer learning and gradual but systematic implementation of reforms.

The book has benefited from a wide range of discussions with public officials in SMICs, including at a seminar held in Mauritius in November 2014 that relied on multistakeholder cooperation to bring together 18 high-level economic officials from seven sub-Saharan African SMICs to examine how to avoid the "middle-income trap." At this event, SMIC authorities saw merit in pursuing peer learning—a combination of policy dialogue and capacity development that has been used relatively rarely by the IMF—to help move reforms forward in their countries and considered the book a useful tool in this effort.

The book also has broader applicability to sub-Saharan Africa because it highlights what lies ahead for a number of fast-growing frontier market economies in the region that are on their way to graduating to middle-income status and may well experience challenges similar to those faced by the SMICs in the region.

Finally, this book represents an excellent collaborative effort with country officials in SMICs and what I hope is the beginning of a deeper policy dialogue between these members and the IMF on ways to implement reforms that would unlock their potential. As demonstrated by the IMF's involvement in other peer groupings (for example, the Group of 20, the Group of 24, the BRICS [Brazil, Russia, India, China, and South Africa], and the UN Small States), the expertise of IMF staff can assist country authorities in realizing their potential. We trust that this book can contribute in a similar way to SMICs as they try to break the glass ceiling of the middle-income trap and move to advanced economy status.

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Acknowledgments

The authors would like to thank the country authorities of Botswana, Cabo Verde, Lesotho, Namibia, Mauritius, Seychelles, and Swaziland for their input and for their helpful comments on an earlier draft of this publication. The authors would also like to thank Ana Semedo, Carla Cruz, Elizabeth Charles, Emma Haiyambo, Erwin Niamhwaka, Jittendra Bissesur, Matthew Wright, Prakash Hurry, Rachna Ramsurn, Sen Narrainen, Sephooko Motelle, Tau Puseletso, and Pako Thupayagale for their contributions. Thanks go to AFRITAC South; AFRITAC West-2; the Regional Multidisciplinary Centre of Excellence in Mauritius, especially Vitaliy Kramarenko and Bertrand Belle, for organizing a technical workshop in Mauritius during November 18–21, 2014, where the key findings of this book were discussed, accompanied by a training session for the various contributors from the seven countries. We are particularly indebted to Anne-Marie Gulde for her overall guidance and wise counsel, including on strategic issues, and for her strong support for the SMIC project from its inception all the way to final publication of this book. Bertrand Belle also deserves special mention for having assisted us in following up with and coordinating the comments from the various country authorities and for his contributions to Chapter 6. Our gratitude also goes to Antoinette M. Sayeh and the other Senior Reviewers in the African Department for their support for this publication. Thanks also to our two reviewers—Andrew Berg at the Institute for Capacity Development of the IMF and Dr. Yaw Ansu of the African Center for Economic Transformation, in Accra, Ghana—for their insightful commentary and useful suggestions. We are also indebted to the IMF's Communications Department and other IMF colleagues for their comments and support. This publication would not have been possible without the excellent research assistance of Andrew Jonelis, who contributed to two chapters of the book; Mounir Bari, who also provided excellent research assistance at the final stage of the publication; and the editorial support of Breda Robertson. All remaining errors or omissions are, of course, our own.

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CHAPTER 1

Introduction

LAMIN LEIGH, ALI MANSOOR, FRISKA PARULIAN, AND ANDREW JONELIS

BACKGROUND

Sub-Saharan Africa has experienced strong growth since 1992, prompting many observers to argue that the region has reached a turning point in its development history and is poised to play a more significant role in the global economy (often called "Africa Rising"). However, economic development among the sub-Saharan African countries varies widely; the majority are still low-income countries (LICs), of which some are fragile states, and the rest are middle-income countries (MICs).

Among the MICs, the small middle-income countries (SMICs) have their own peculiarities. They are generally characterized by several features, such as (1) small populations, (2) annual per capita income in the range of \$3,000–\$10,000, (3) low levels of financial intermediation and financial inclusion compared with a typical emerging market economy, (4) undiversified economies, and (5) high levels of income inequality and unemployment.

Despite those challenges, most SMICs have delivered impressive economic performance in the past few decades (Figure 1.1, and see Annex 1.1 on Cabo Verde). A prolonged period of strong growth raised overall incomes and delivered good economic outcomes. The GDP per capita of SMICs in sub-Saharan Africa on average increased more than fivefold during the past 30 years, compared with an average increase of only 1.7 times for the rest of sub-Saharan Africa (Figure 1.1).

Prudent macroeconomic management, coupled with improved institutional settings in many SMICs in sub-Saharan Africa, contributed to better economic outcomes.

- Over the years, the policy implementation capacity of many SMICs has improved significantly and is now close to that of large MICs in other regions. A number of SMICs have maintained fairly disciplined fiscal stances with relatively low debt-to-GDP ratios. Given the prevalence of pegged exchange rate regimes in SMICs, by and large most of them have maintained strong external positions. SMICs in general have relatively more-developed financial systems; and their vibrant and rapidly expanding nonbank financial sectors demonstrate the greater sophistication of their financial systems, including the increasing use of technology to improve financial system efficiency.

- SMIC governments have also generally addressed their development challenges effectively, including by narrowing the infrastructure gap and facilitating access to education and health. In general, SMICs score well on the human development index (HDI), including the levels of education and absolute poverty.

However, SMICs exhibit a significant degree of heterogeneity across various dimensions. This heterogeneity is most evident in the evolution of GDP per capita across their economies since the 1980s (Figure 1.1). Although per capita incomes in the early 1980s were not very different, current income levels vary significantly across SMICs reflecting, in part, the relative strength of their policies over the years. In the same vein, poverty rates are very different across SMICs (see Chapter 4). The financial landscape also varies from country to country. Although the sophistication of Mauritius's financial system is much closer to that of emerging markets, and Botswana's pension system is relatively more advanced and closer to that of large MICs, other SMICs, such as Lesotho and Swaziland, are not as equally advanced in these areas. The political economy constraints to reform are also not uniform across SMICs (see Chapter 6). Moreover, the momentum to move forward may be different. Some of the SMICs had relatively high per capita income growth rates at the time of graduation to MIC status, and this momentum carried forward in bringing them to

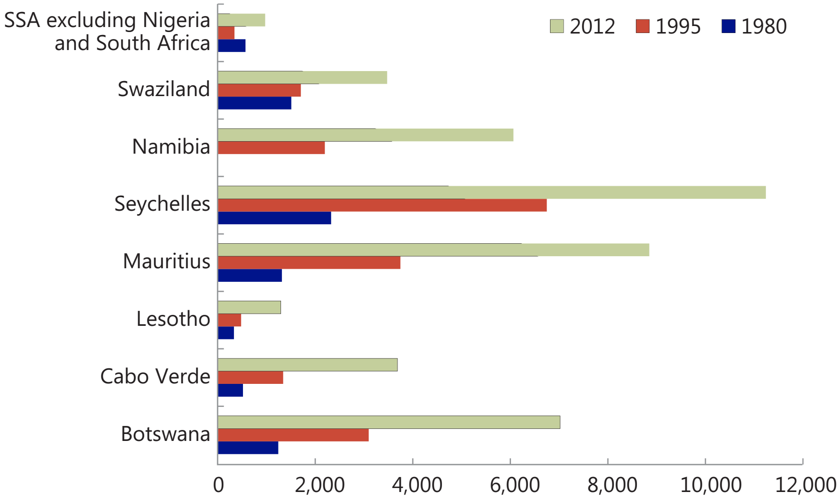


Figure 1.1 GDP per Capita for Small Middle-Income Countries

Source: IMF, World Economic Outlook database.
Note: SSA = sub-Saharan Africa.

the ranks of the upper-middle-income countries (Botswana, Mauritius, and Seychelles). Others graduated with much less growth momentum, positioning them less well for the journey to advanced economy status (Lesotho and Swaziland). Thus, even the SMICs that need to accelerate their growth rates may take the opportunity to learn from the institutional arrangements and policy stances of the more successful SMICs.

However, as in many other MICs in other regions, growth rates in SMICs have been slowing during the past few years (well before the 2008–09 global financial crisis). For some of them, even though HDI indicators remain respectable, significant improvements have not been made since 2005. The question then becomes whether past policies on intensive capital investment (capital deepening) have run their course and to what extent they have underpinned sustained gains in productivity driven by structural reforms that would support sustainable high growth over the medium term. In this respect,

- High unemployment rates persist in many SMICs despite public employment that contributes to relatively large governments, reflecting in part a host of distortions in labor markets. In many of the recent IMF Article IV consultation discussions with SMICs, IMF staff have highlighted the need for policy action to reinvigorate productivity growth. Such actions should include implementation of growth-promoting structural reforms, most notably reforms that improve the quality of public spending, address the skills mismatch in the labor markets, reduce the regulatory burden on firms, and facilitate structural transformation in the SMICs' economies.
- Moreover, although the financial sector in SMICs continues to deepen, with global regulatory reform providing input into national regulatory settings, financial inclusion tends to lag in many of them compared with their peers outside the region as a result of a host of supply-side and demand-side constraints that keep financial intermediation costs high.
- Overall, the benefits of past growth have also not been evenly shared across the population; many of the SMICs are among the most unequal in the world. Although many SMICs have large and extensive social safety nets, some of these social programs have not been well targeted, suggesting that fiscal policy has a role to play in enhancing more inclusive growth in these economies.

Thus, the policy thrust of many of the SMICs' recent national development plans (the so-called Visions 2020 or 2030) has stressed the need to respond to these challenges by reducing the size of the government relative to GDP so that the private sector can take the lead in driving economic prospects. The key objectives of these medium-term strategies are framed around policies to boost economy-wide productivity and enhance job creation to pave the way for higher, sustainable, and more inclusive growth. SMIC governments aim at "prosperity for all," with the goals of poverty eradication, more equitable distribution of income, and rapid growth and economic diversification.

The rest of this introductory chapter describes the common policy challenges facing SMICs. It also compares SMICs with countries that have succeeded in becoming high income to identify applicable policy lessons and institutional arrangements that can help shed light on policies that could unlock the growth potential of SMICs in sub-Saharan Africa and enable them to avoid the middle-income trap.

COMMON POLICY CHALLENGES IN SMICS

The common policy challenges facing SMICs can be described as follows:

- Although many SMICs no longer face the critical macro-stability issues that are prevalent in some LICs in sub-Saharan Africa, because they are largely undiversified and highly open economies they tend to be much more vulnerable to global shocks and the associated outward economic spillovers. Accordingly, like other small states, they have generally experienced a high degree of growth and current account volatility, reflecting concentrated production and export structures.
- Some of the SMICs are still trying to close their infrastructure gaps and are using their fiscal policy frameworks to help address this development challenge while preserving macroeconomic stability. This approach poses particular challenges given the underlying rigidities in their fiscal positions that limit the use of countercyclical policy actions in the event of shocks. Specifically, on average, wage bills and transfers and subsidies to state-owned enterprises tend to account for about 50 percent of total expenditures. Their revenues are also highly concentrated in some cases, with mineral revenues accounting for a significant part of total tax revenues.
- Many SMICs have used public intervention to address their high levels of unemployment. However, such active labor market policies, including public works programs, have yet to generate sustainable job creation in these economies. The issues of unemployment and inequality are closely linked because limited productive employment opportunities for growing populations contribute to high income inequality and rising poverty.
- Many SMICs in the region have experienced a moderation in growth since the mid-2000s. Although factor accumulation contributed significantly to past growth, this growth model appears to have run its course. IMF staff analysis suggests that the decline in the contribution of total factor productivity to growth is largely responsible for the slowdown in trend growth in many SMICs, which highlights the need for policy actions to reinvigorate productivity growth. This situation suggests that one key policy challenge is

identifying the kinds of structural policies that could boost productivity growth in these countries.

- Although these SMICs have financial systems that are relatively more developed, at the individual level, the unbanked portion of the population and the number of firms facing constraints to access to credit or to financing more broadly remains high. The lingering financial sector vulnerabilities, most notably concentration risks in the banking sector and weak regulatory and supervisory capacity in the nonbank financial sector, are also a key challenge. The interplay of concentration and regulatory risks, including the cross-linkages between banks and nonbanks, is also a source of potential vulnerability to financial instability in SMICs. These links raise new sets of financial stability challenges for SMICs in an environment of relatively low financial inclusion, thus reinforcing the need to find an appropriate balance between enhancing financial inclusion and preserving financial stability.
- Why are reforms hard to implement in these countries and what are the political economy constraints to reform? For many SMICs, the impetus for deep-seated structural reform is simply not there. After graduating from low- to middle-income status, as a result of relatively low poverty levels in many SMICs (both in absolute and relative terms),[1] the dominant trend tends toward policies that "muddle through" without radical change. The challenge then becomes to determine how policies can be better sequenced to foster greater institutional and capacity building in SMICs, including through peer learning and peer support, to facilitate reform.

The challenges faced by the SMICs in sub-Saharan Africa are also prevalent in small states in other regions, such as the Pacific Islands and the Caribbean. Like the SMICs in sub-Saharan Africa, these other small states have performed reasonably well for an extended period, with per capita income levels (Figure 1.2) and social indicators that are broadly in line with those of their larger comparators. However, despite prolonged policy efforts, economic growth has generally slowed in these other small states since the late 1990s, and they continue to experience relatively high levels of macroeconomic volatility. They share common characteristics with the SMICs in sub-Saharan Africa, such as high trade openness, high government wage bills, public sector dominance, heavy reliance on trade tax revenues (as in some members of the Southern African Customs Union), and the frequent use of fixed exchange rates as a monetary anchor. SMICs in sub-Saharan Africa tend to show some differentiation from small states in the Pacific Islands and the Caribbean in the level of the overall debt burden, with debt levels by and large

[1] The poverty level according to the World Bank's definition (the proportion of the population living on less than $1 or $2 a day) remains broadly at or below 25 percent of the population, which is comparable to the poverty levels in a number of large emerging markets.

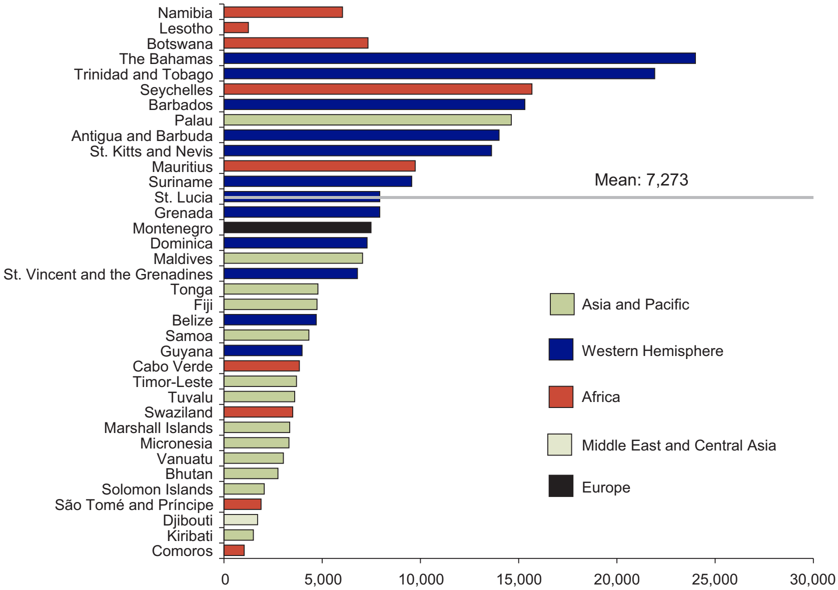


Figure 1.2 Small States, GDP per Capita 2014

Sources: IMF, World Economic Outlook database; and World Bank, World Development Indicators.

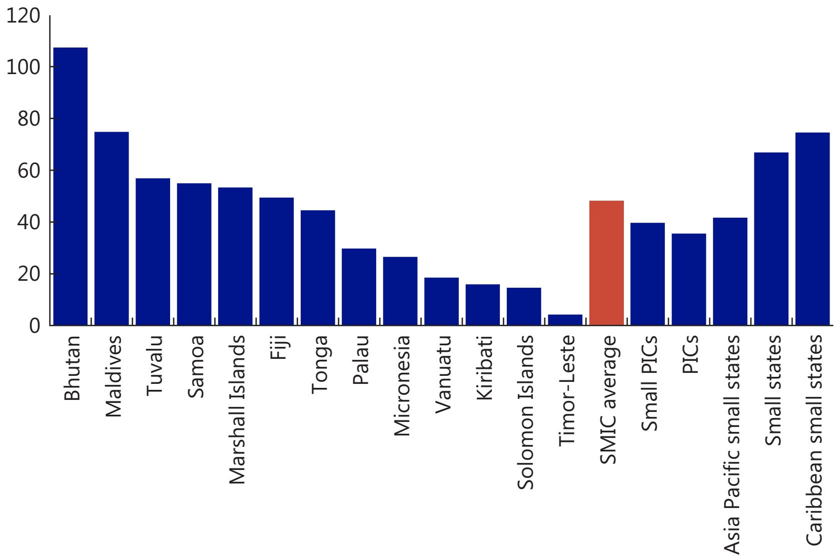


Figure 1.3 Small Middle-Income Countries and Small States, Public Debt, 2014

Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: PICs = Pacific island countries; SMIC = small middle-income country.

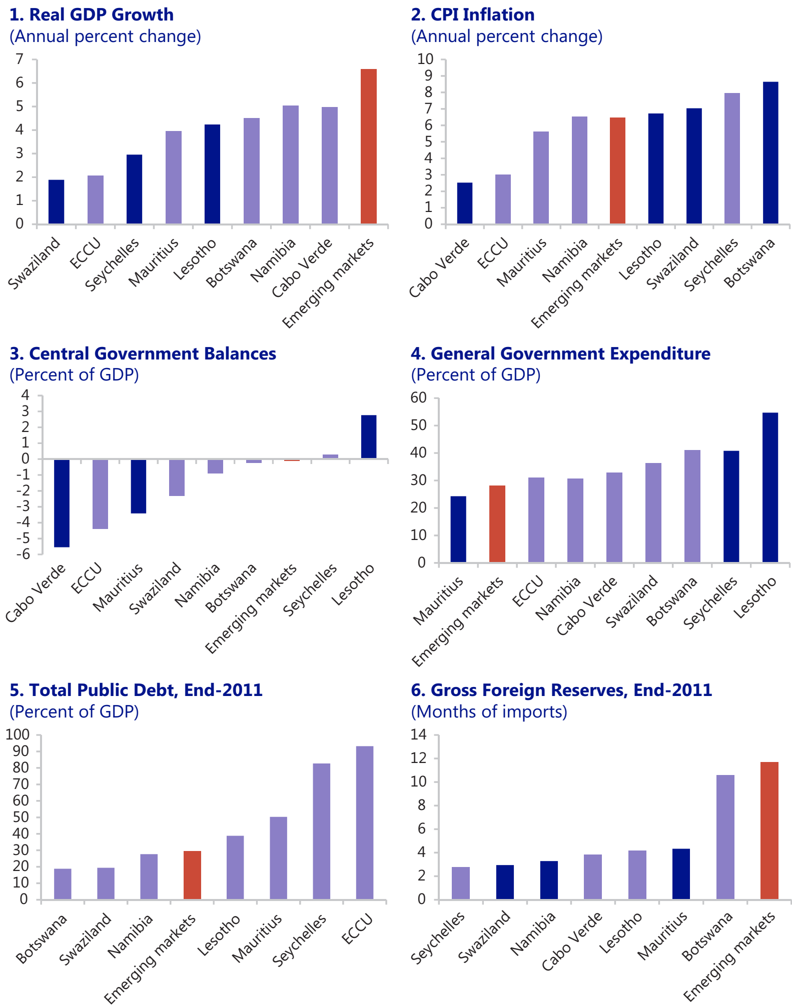


Figure 1.4 Small Middle-Income Countries in Sub-Sarahan Africa: Regional Comparison (Average 2002–12, unless otherwise indicated)

Sources: Country authorities; IMF, World Economic Outlook database; and IMF staff estimates.
Note: CPI = consumer price index; ECCU = Eastern Caribbean Currency Union.

being much lower than that of their peers in the Pacific and the Caribbean (Figure 1.3). In summary, whereas SMICs in sub-Saharan Africa are in a position of both low growth and low debt, other small states outside the region are in a situation of low growth and high debt, as shown in Figures 1.3 to 1.6. Using the available fiscal space wisely will be one of the challenges, and this book makes some suggestions in this direction.

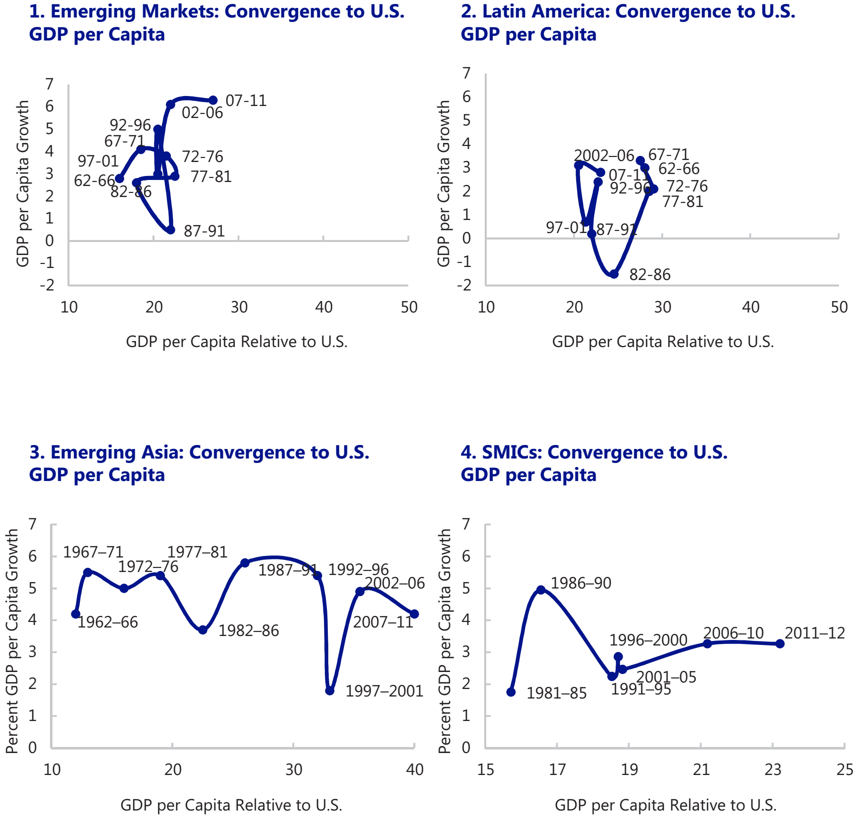
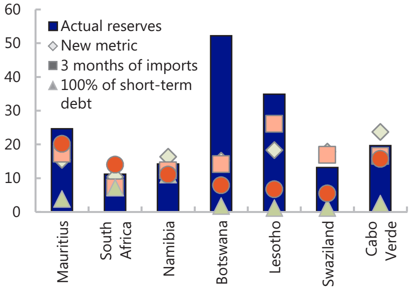


Figure 1.5 Growth Convergence in Small Middle-Income Countries Relative to Other Country Groupings

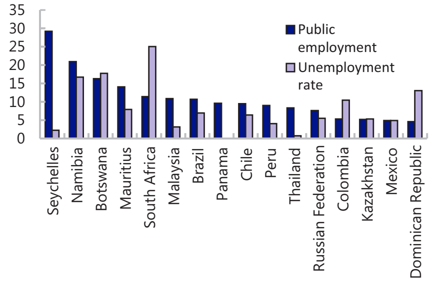
Sources: Penn World Tables; World Bank data; and IMF staff estimates.

Note: GNI = gross national income; HIC = high-income country; SMICs = small middle-income countries; WEO = IMF's World Economic Outlook database.

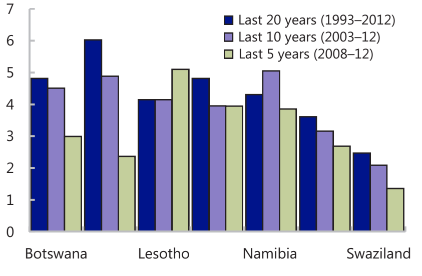
1. Selected Middle-Income Countries in SSA: Reserves Adequacy, 2012
(Percent of GDP)



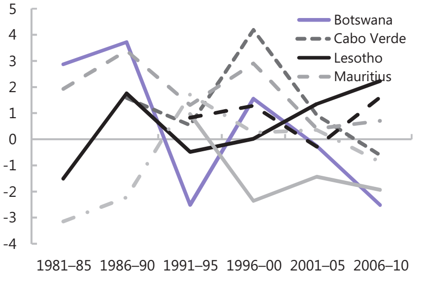
2. Public Employment and Unemployment Rate
(Public employment average, 1995–2011: Unemployment, latest)



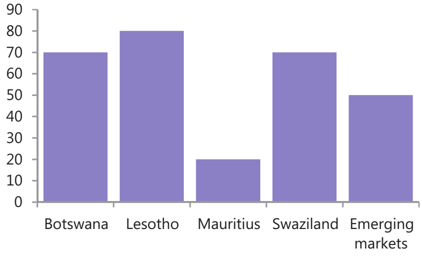
3. Real GDP Growth in SSA SMICs
(Percent)



4. TFP Contribution to Growth
(Percent)



5. Unbanked Population (Percent)



6. Firms Identifying Finance as a Major Constraint (Percent)

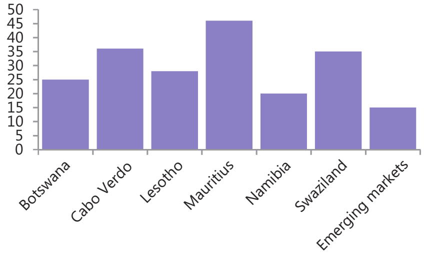


Figure 1.6 Common Policy Challenges Facing Small Middle-Income Countries

Sources: Country authorities; IMF, World Economic Outlook database; Penn World Tables; World Bank data; and IMF staff calculations.
Note: SMICs = small middle-income countries; SSA = sub-Saharan Africa; TFP = total factor productivity.

BROAD EXPERIENCES IN GRADUATING FROM MIDDLE-INCOME TO HIGH-INCOME COUNTRY STATUS

In 1960, 81 states were classified as MICs. Between 1960 and 2012, 35 out of 69 LICs graduated from LIC to MIC status but only 16 countries[2] (Figure 1.7) graduated from MIC to advanced economy status.[3,4] Assuming a similar wealth distribution within each income bracket, the result is interesting. Between 1960 and 2012, fewer than 20 percent of MICs—and none from sub-Saharan Africa—became high-income states; in comparison, more than half of LICs graduated to middle-income status.

Kharas and Kohli (2011) first coined the term "middle-income trap" to describe the fact that graduating from MIC to HIC status appears to be harder than graduating from LIC to MIC status, based on the observation that MICs graduated to HIC status far less often than LICs became MICs.

Several studies define avoiding the middle-income trap as a matter of growing fast enough to cross the lower-middle-income threshold in at most 28 years (which requires a growth rate of at least 4.7 percent per year), and the upper-middle-income threshold in at most 14 years (which requires a growth rate of at least 3.5 percent per year; for example, Felipe, Abdon, and Kumar 2012). Thus, today's development challenge for many SMICs is how to accumulate sufficient productive capabilities to result in a more diversified export basket that includes products that are more complex and that require more capabilities and differentiation than products produced on a mass scale. As part of their strategies to become HICs, countries in the middle-income trap have to make efforts to acquire a revealed comparative advantage in sophisticated and well-connected products.

The literature offers a variety of reasons for why MICs find it difficult to graduate to HIC status. Among others, Eichengreen, Park, and Shin (2013); Felipe, Abdon, and Kumar (2012); Gill and Kharas (2007); Kharas and Kohli (2011); Lee and Kim (2009); and Peerenboom and Ginsburg (2013) suggest that in the end it comes down to remaining competitive as wages rise even though factor productivity may

[2] Cyprus, the Czech Republic, Estonia, Greece, Hong Kong SAR, Ireland, Japan, the Republic of Korea, Latvia, Malta, Portugal, Singapore, the Slovak Republic, Slovenia, Spain, and Taiwan Province of China.

[3] The official IMF definition of advanced economies does not explicitly consider human development. However, all advanced economies also score highly on the United Nations Development Programme's Human Development Index (HDI). In view of the importance of inclusive growth for both equity and economic growth (see Balakrishnan, Steinberg, and Syed 2013), progress in this area should also be part of the agenda for SMICs aspiring to graduate to advanced economy status. The target set for this volume is the minimum HDI score achieved by a graduated MIC.

[4] The IMF's *World Economic Outlook* reports "industrial" economies as the highest echelon, with 23 in this group in 1999. In 2014 the highest echelon was "advanced" economies, with 36 members including the initial 23 industrial economies. In 1999 there were 37 upper-middle-income countries, a number that rose to 55 in 2013. Some 35 countries graduated to MIC status between 1999 and 2013 and no country regressed from upper-middle-income status. The 16 countries discussed here exclude those countries with relatively low populations that have large natural resource bases and that became high income without the economic diversification or integration into global financial markets that would make them advanced economies.

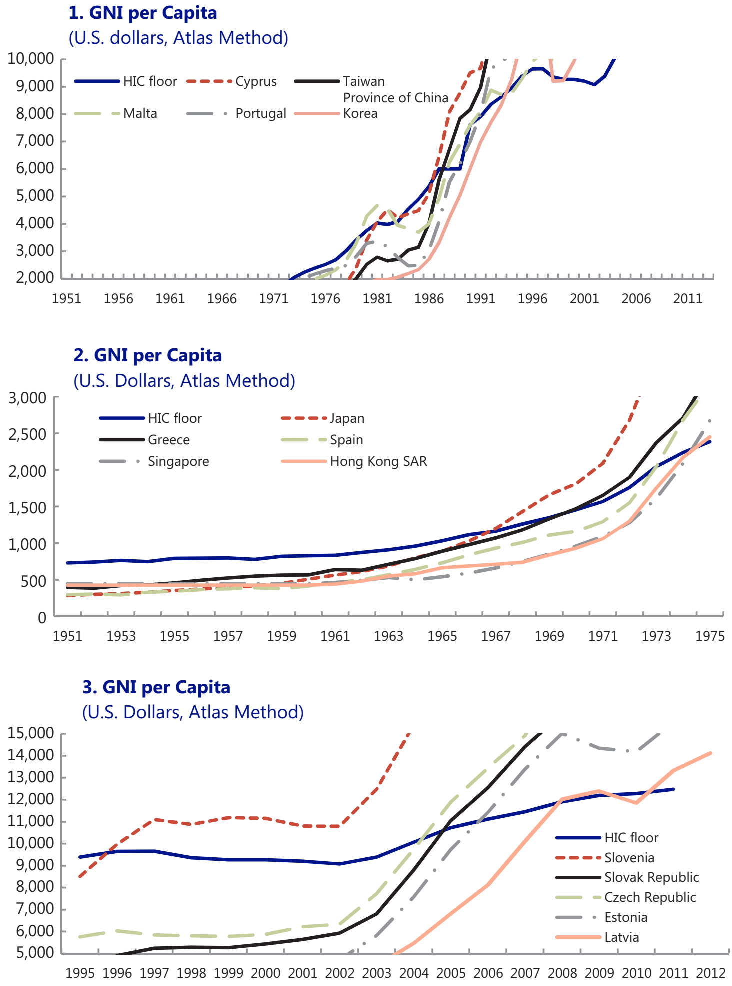


Figure 1.7 Graduation from Middle-Income Status since 1960

Sources: World Bank data; and IMF staff calculations.
Note: GNI = gross national income; HIC = high-income country.

lag and remain lower than in higher-income competitors. Thus, the unifying theme of this book is how to raise productivity to avoid the middle-income trap.

Traits of Graduating Middle-Income Countries

To understand how the SMICs in sub-Saharan Africa might approach reform, it may be useful to consider some of the characteristics and circumstances of the countries that have managed to address the issue and graduate to advanced economy status. These characteristics include the following, among others:

- An ideology that involves some concept of a social contract between governments and those they govern.

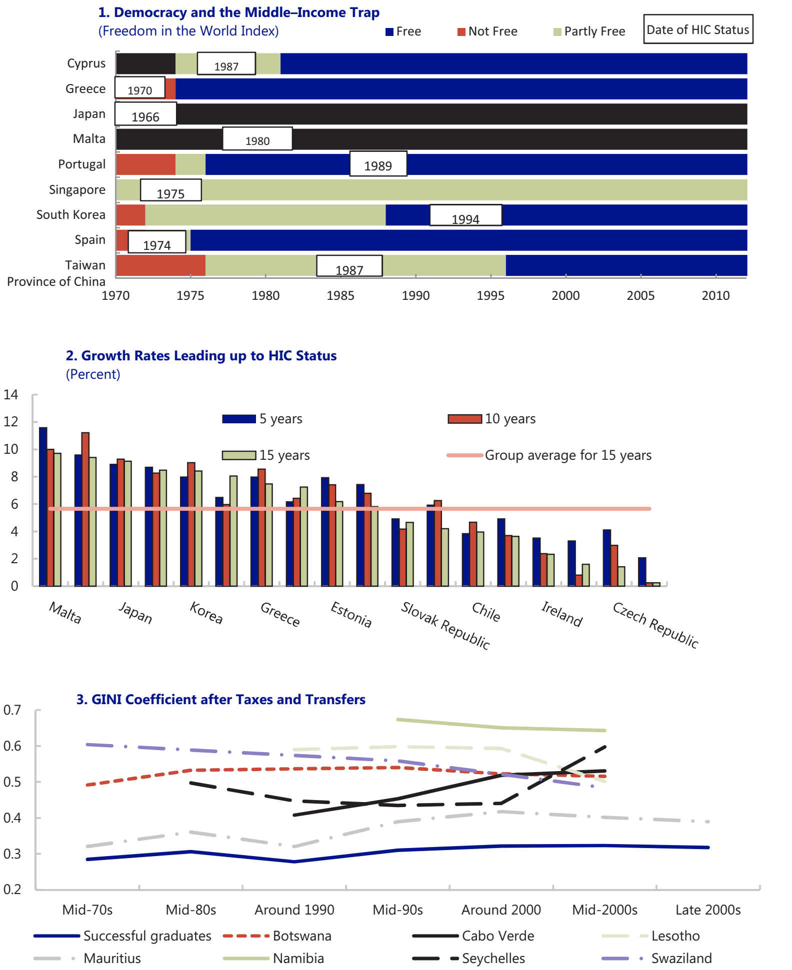


Figure 1.8 Graduate Middle-Income Countries, Democracy, and Income Inequality

Sources: Freedom House; IMF, World Economic Outlook database; World Bank data; the Standardized World Income Inequality Database; and IMF staff calculations.
Note: HIC = high-income country.

- Societies that became progressively more politically open and inclusive (Figure 1.8).[5] Moreover, there may be a democratic dividend: as these countries move toward advanced economy status, instead of growth declining (which growth convergence theory or regression toward the mean would suggest), growth is maintained or even accelerates.
- Openness to capital, trade, and labor (Figure 1.9).

[5] It is not clear that the causality is from political openness to prosperity, but beyond the association it is possible that the two processes are mutually reinforcing. A larger middle class with a greater share in the economy usually demands better services and more political openness. At the same time a political system that gives more space may facilitate the emergence of a middle class.

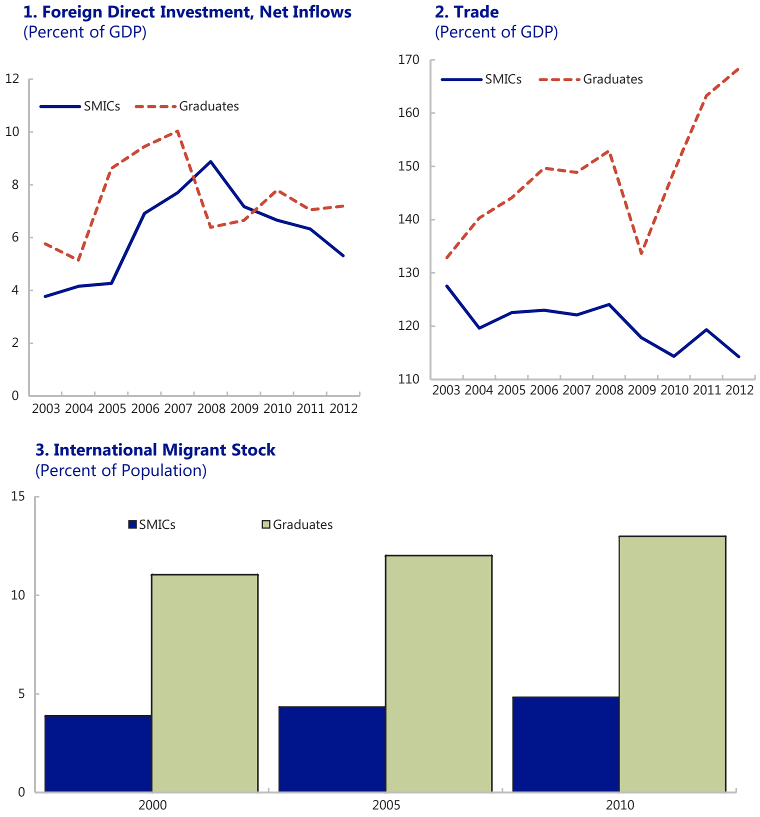


Figure 1.9 Small Middle-Income Countries (SMICs) and Graduate Middle-Income Countries: Openness to Capital, Trade, and People

Source: World Bank.

In some countries, the following also may have played a role:

- A permanent sense of urgency in view of recovery from a major shock or potential crisis (Cyprus, the Czech Republic, Estonia, Hong Kong SAR, Japan, Latvia, Singapore, the Slovak Republic, Slovenia, Korea, Taiwan Province of China).
- A clear road map for reforms and economic policies that emanates from regional clubs such as the European Union (Cyprus, the Czech Republic, Estonia, Ireland, Latvia, Malta, the Slovak Republic, Slovenia).
- A champion for reform (Singapore's Lee Kuan Yew, Korea's President Park, and Taiwan Province of China's Chiang Kai-Shek).

Some may argue that many of the items associated with countries that successfully made the transition from MIC to advanced economy status may be luxury goods rather than necessary components of success. It is likely that there may be virtuous circles whereby luxury goods can be consumed as income goes up and rising income supports reforms that enable the production of these luxuries. This would reinforce the argument that reformers should focus efforts on producing such results as part of avoiding the middle-income trap to move to advanced economy status.

Along the same lines, there is an overlap between constraints on reform and constraints on productivity, an issue discussed in more detail in Chapter 4. Experience suggests that there may be a virtuous circle whereby actions to unleash productivity (if the political economy constraints can be addressed) can facilitate further, and possibly broader, reforms.

Post Hoc Ergo Propter Hoc?[6]

The above should be seen as possibly necessary conditions but not sufficient for graduation. For example, many countries are members of regional clubs such as the Common Market for Eastern and Southern Africa, the Southern African Development Community, and the West African Economic and Monetary Union but have not followed an appropriate reform path to becoming HICs.

Surely It's All about Short-Term Political Interest

One summary political economy explanation for the middle-income trap in democratic systems is that politicians with short time frames (the electoral cycle) prefer to accept a low but positive growth rate (say 2 percent) that requires no difficult measures rather than take risks implementing reforms that would unlock growth greater than 5 percent. This explanation is even more likely if it is a successor government that would get most of the benefits. This consideration is relevant because most of the SMICs in sub-Saharan Africa are democracies.

Taking a broader view of this issue, Acemoglu and others (2014) conclude that democracy has a significant and robust positive effect on GDP. They suggest that democratization increases GDP per capita by about 20 percent in the long term. Democracy increases future GDP by encouraging investment, increasing schooling, inducing economic reforms, improving provision of public goods, and reducing social unrest. Similarly, Bates and Block (2013) find that the introduction of competitive presidential elections is significantly related to the resurgence of productivity growth in African agriculture. The emergence of electoral competition appears to have altered political incentives, resulting in both sectoral and macroeconomic policy reforms that strengthened productive incentives in farming. Moreover, a lower democracy score is associated with a lower score on other World Governance Indicators, such as control of corruption, rule of law, regulatory quality, and government effectiveness (Figure 1.10).

In line with earlier discussion in this chapter, democracy is perhaps best viewed as a luxury good, the production of which rises with the movement to advanced economy status. At the same time, reforms that enhance the democratic space can facilitate the transition from MIC to advanced economy, and in several countries that completed the journey both the democratic space opened and economic growth accelerated. Beyond that, the challenges for reformers are real in a

[6] Translated from the Latin as "after this, therefore because of this." This is a logical fallacy because it states "since event Y followed event X, event Y must have been caused by event X."

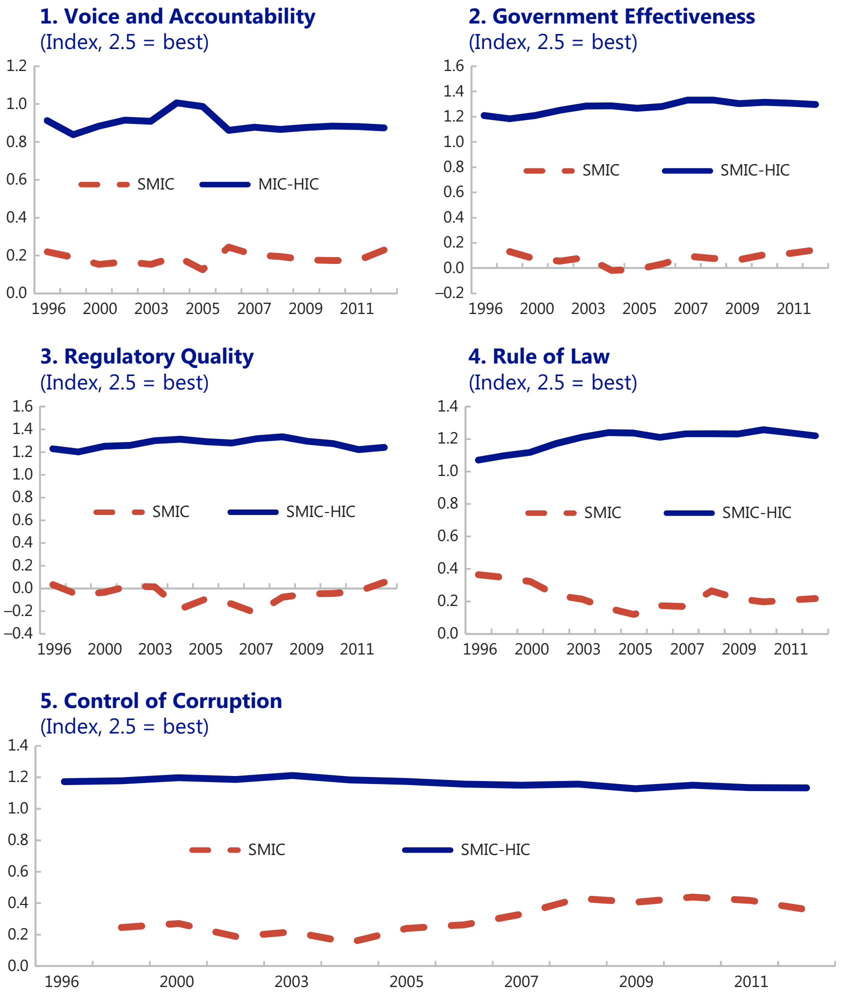


Figure 1.10 Small Middle-Income Countries and Graduated Middle-Income Countries: Comparator Governance Indicators

Source: Worldwide Governance Indicators.
Note: HIC = high-income country; MIC = middle-income country; SMIC = small middle-income country.

democracy in which the politicians' short-term horizons may make it harder to build the coalitions required for reforms with long-term payoffs.

Or Perhaps It Is Reform Fatigue?

The impetus for reform is further dimmed by popular perceptions. A SMIC's population can become complacent and resist changes that have short-term costs even if the long-term benefits are large. The country has made it from low to middle income and living standards keep improving even if slowly. The dominant view can then favor muddling through without radical change.

Maybe an Inability to View Immigration as an Economic Catalyst?

One particular illustration concerns openness to labor inflows, a subject for which an interesting contrast can be made between the most liberal of the SMICs in sub-Saharan Africa, such as Mauritius and Singapore. Until the late 1980s and early 1990s, Mauritius and Singapore were on similar growth and economic transformation trajectories. Thereafter, their GDP per capita levels diverged rapidly, with Singapore virtually quadrupling its GDP per capita while Mauritius could "only" double its. During that period, Singapore became more integrated into the global labor market, with its population rising from 2.4 million in 1980 to 5.4 million in 2013, of whom about 40 percent were foreign born. In contrast, Mauritius kept its labor market much more closed; its population grew from about 1 million to only 1.3 million during the same period, and the share of foreign born was less than 4 percent.

Wait a Minute, Are These All Similar?

All of the above hypotheses harbor sources of divergence between SMICs in sub-Saharan Africa and graduated MICs. Each of these hypotheses has at least one of the following traits:

- It is notoriously hard to quantify the effects of these hypotheses because of the absence of counterfactuals and the inability to test them using randomized control trials.
- Agreement on the appropriate measures to address each of the problems is hard to achieve, as expected with subjective issues.
- The reforms required to address each of the hypotheses are multipronged, and unlike MIC or advanced economy status, progress cannot be computed, and success cannot be stated as the time when X measurement surpasses Y threshold.

The analysis here shows a number of areas of divergence between SMICs in sub-Saharan Africa and graduated MICs. However, coming to agreement with a technical peer on which measures need to be carried out, why, over how long, and when to know whether the measures have worked would be an enormous task.

Consider convincing at least a majority of the ministerial cabinet, the opposition, civil society, political and entrepreneurial elites, and the electorate at large of the reform agenda, and we are in the position of the authorities in a number of the SMIC countries. Therein lies the challenge with implementation of the finer reforms that could nudge SMICs in sub-Saharan Africa to graduate to the advanced economy club.

SMICs in sub-Saharan Africa grew at an average annual pace of about 3 percent from 2009 to 2012, less than half the pace of the emerging markets. Although the growth rate is low, it is still positive, which may explain why SMICs may be trapped in a stable but suboptimal Nash equilibrium.[7] No one is willing

[7] A Nash equilibrium is stable and persists because no participant can gain from a unilateral change of strategy if the strategies of the others remain unchanged. Hence, in the country's economy all the participants perceive the expected cost of changing the status quo to be higher than the expected benefit if more than one player were to change.

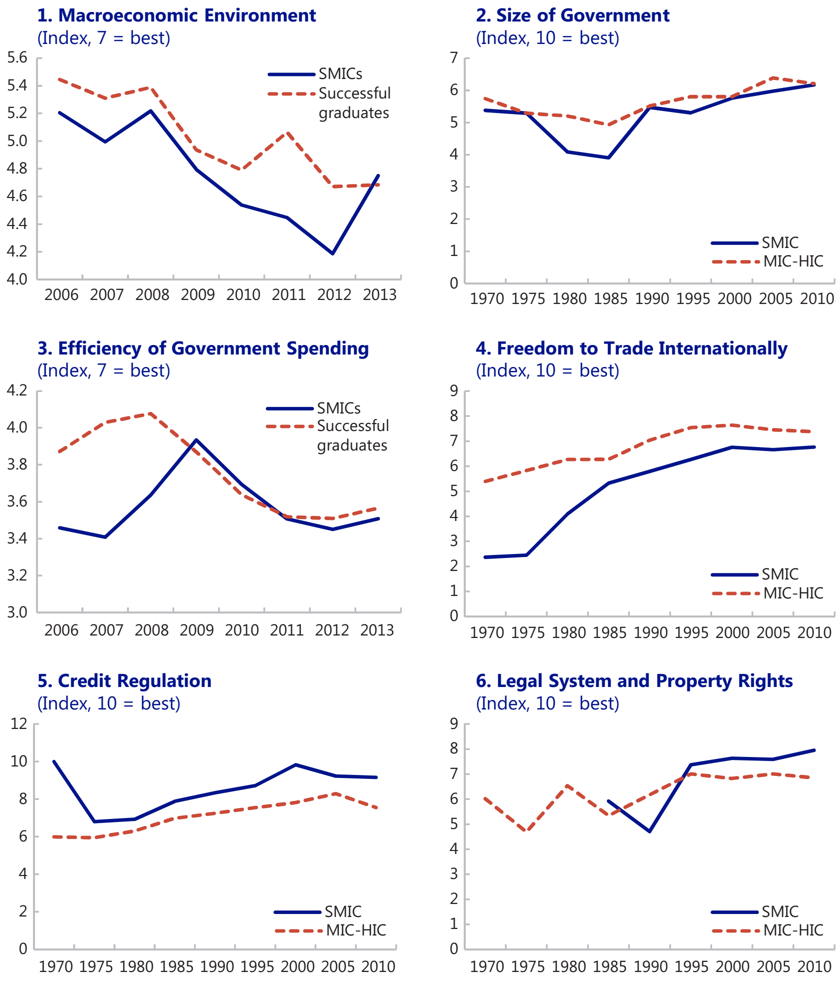


Figure 1.11 Economic Indicators: Areas in Which Small Middle-Income Countries Are Performing at Levels Comparable to Graduated Middle-Income Countries

Sources: Fraser Institute, Economic Freedom of the World: Annual Report 2014; and World Economic Forum.
Note: HIC = high-income country; MIC = middle-income country; SMIC = small middle-income country.

to pay the short-term price of diverging from the existing policy because the perceived short-term risks are high and the status quo is relatively comfortable. This stasis may also reflect the existence of a small political and entrepreneurial elite—comprising people with close ties to one another—that helps consensus to be achieved but may slow down major reforms.

Figure 1.11 shows the economic areas in which the SMICs in sub-Saharan Africa are performing at comparable levels to countries that have made the transition to advanced economy status. As noted above, SMICs in sub-Saharan Africa have strong implementation capacity, particularly in their ministries of finance and central banks. SMICs in sub-Saharan Africa have used this capacity to do just as well as graduated MICs to ensure macroeconomic stability, deliver relatively efficient spending, liberalize trade, and protect property rights. In credit regulation, SMICs in sub-Saharan Africa actually perform better than graduated MICs. The reforms required to achieve this positive outcome are in areas in which the policy goal is clearer, the benefits easier to support with empirical evidence, and the implementing agencies more easily identified and adequately staffed.

However, in areas outside the purview of the ministries of finance and central banks, the sub-Saharan African SMICs have done less well in emulating graduated MICs (Figure 1.12; these areas are covered in more detail in subsequent chapters). The SMICs also need to make sure that growth is inclusive and that they raise their HDIs to the level achieved by the graduated MICs (Figure 1.13). This goal suggests, as discussed below, that the SMICs in sub-Saharan Africa may wish to focus on improving educational attainment and health care services, as illustrated in Figure 1.12.

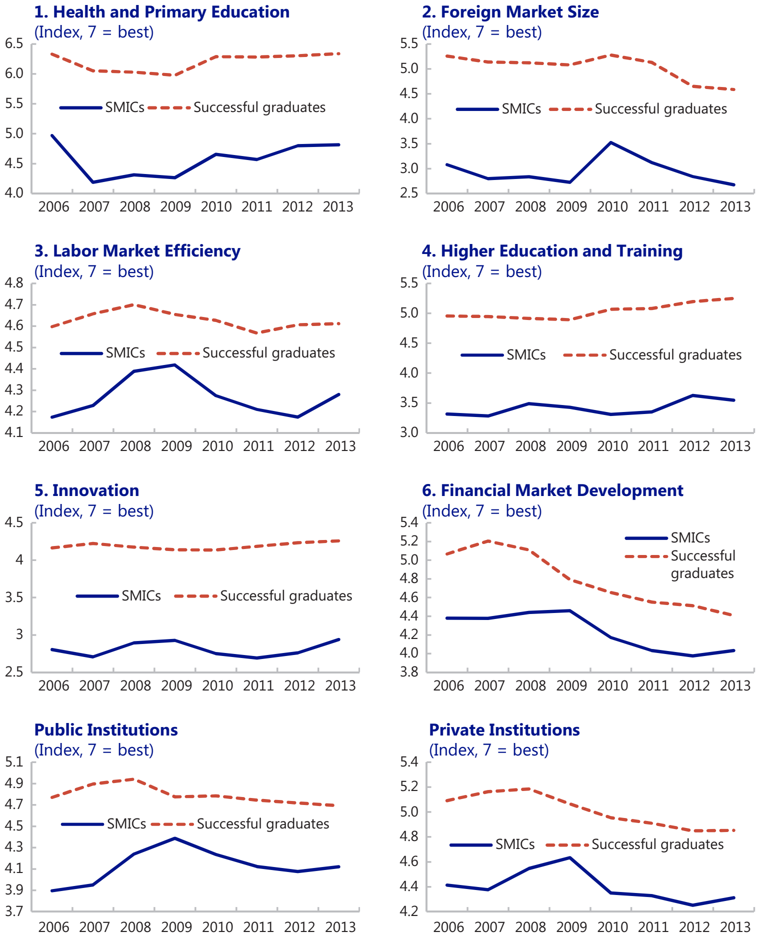


Figure 1.12 Comparator Economic Indicators: Areas in Which Small Middle-Income Countries (SMICs) Underperform Relative to Graduated Middle-Income Countries

Source: World Economic Forum.

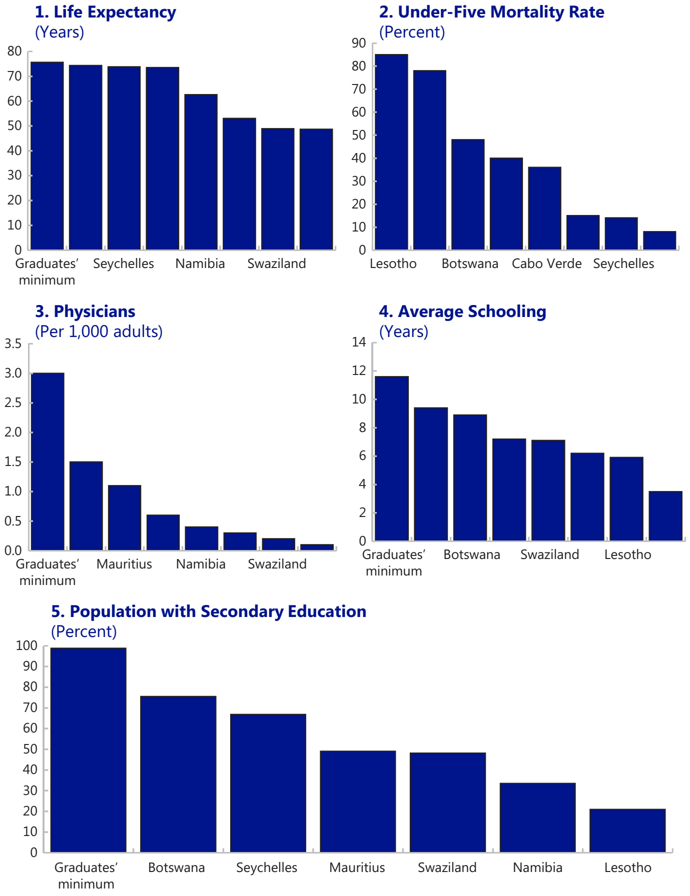


Figure 1.13 Selected Human Development Indicators in Small Middle-Income Countries Compared with Graduated Middle-Income Countries

Source: United Nations.

For the SMICs to emulate the graduated MICs, they will need to build on the gains identified in Figure 1.12 to address the lagging reform areas. These reforms go beyond the ministries of finance and central banks, are sometimes harder to define, and often require coordination across several agencies.

COUNTRIES THAT HAVE ADVANCED FROM MIC TO HIC STATUS—APPLICABLE POLICY LESSONS AND INSTITUTIONAL ARRANGEMENTS FOR SMICS

No single reform path can be used to propel any economy from middle-income to high-income status. Many MICs have moved to HIC status by enacting reforms that had significant impacts on productivity and growth (Chile, Korea, and Singapore, for example). Historical experience suggests that investment in education and human capital and real and financial sector reforms can spur productivity, and thus growth. However, the impact of these reforms can be limited if they do not address the most binding constraints to growth within a country (Hausmann, Rodrik, and Velasco 2008).

Thus, this section focuses on selective country case studies to build on the previous analysis and identify applicable policy lessons that could be drawn for SMICs as they chart the course toward HIC or advanced economy status.

Cross-country research shows that in general a stable macroeconomic framework, openness to trade, strong institutions, and a well-developed financial system are key to strong and sustained growth.[8] An IMF study also finds that, in addition, more equality in income distribution is robustly correlated with longer growth spells (Berg, Ostry, and Zettelmeyer 2012), pointing to the need to make growth more inclusive to improve the pace and sustainability of overall growth.[9,10]

Simple data analysis in this chapter also shows that MICs that have managed to move up to HIC status have several common characteristics, such as more equal income distributions and lower unemployment rates, high government effectiveness, and active private sectors that support the government's efforts to protect investors and ease access to credit. In general, the private sector usually takes the lead in the growth process during the transition to high-income status.

The selected country case studies also show that graduated MICs have a number of common characteristics:[11]

The implementation of policies and reforms benefited from well-designed sequencing and a focus on education and the upgrading of the human capital base to lift productivity from the start.

After graduation from LIC to MIC status, countries that subsequently achieve HIC status tend to be the ones that move quickly to the next generation of reforms with a special focus on augmenting the human capital base. The policy focus of reforms shifts to the upgrading of human capital to help boost economy-wide productivity growth. MICs that manage to graduate to HIC status tend to

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[8] These factors are observed mostly in Asian experiences, as discussed, for example, in Krugman (1994), Page (1994), Stiglitz (1996), and World Bank (1993). See also Chapters 2, 3, and 4 for more insight.

[9] Basdevant, Benicio, and Yakhshilikov (2012) apply the findings of Berg, Ostry, and Zettelmeyer (2012) and the results show that income inequality, based on the Gini coefficient, is one of the main determinants of the duration of growth spells in the majority of the SMICs that are the subject of this book. Specifically, in Namibia, the duration of growth spells could triple if income inequality were to be reduced to the levels prevailing in a group of MICs with the same level of development.

[10] Almost all advanced economies have Gini coefficients of less than 0.5. Income inequality can lead to wasted productive potential and misallocation of resources, and may prevent capital and labor from being matched as efficiently as possible, thus undermining growth.

[11] The choice of countries for the case studies was in part guided by small open-economy graduated MICs that have undertaken policies that seem to dovetail with the results of the analytic research contained in the subsequent chapters of this book.

show a significant increase in human capital investment over time. Education and development of human resources tend to be the center of government policies to build a knowledge-based economy.

Education spending is carefully allocated, with the initial focus more on strengthening primary and secondary education before moving on to tertiary education. The education system is also tailored to match the needs of industry at each stage of development to address any skills mismatch in the labor market. For example, in the early stages of Singapore's development, the government set up technical schools and paid foreign corporations to train unskilled workers for higher-paying jobs in electronics, ship repair, and petrochemicals. In addition, it used strategies to convince talented individuals to have a stake in the country's overall economic policy.

In MICs that have graduated to HIC status, governments also tend to concentrate on upgrading their technology and product complexity to foster productivity growth. In Malta, another small open economy, the government focused on research and development to enable its industries to move up the value chain and increase the sophistication of its products.

Good governance with the right institutional setting supported an efficient public sector, private sector development, and competitiveness.

In Chile, which is a MIC on the verge of becoming a HIC (or already is a HIC by some measures), regulatory reforms contributed to prolonged strong growth. After the crisis of 1982 that left half of the Chilean banking sector in bankruptcy, the government conducted numerous reforms of the laws regulating corporations and the financial sector. The government recognized that highly qualified professionals are essential to accomplishing fundamental change. Reform became the seed for revitalizing the private sector, which helped to pave the way for Chile's prolonged growth. In Malta, the country's robust legal and regulatory framework is based on European Union directives while remaining business friendly and industry oriented.

Institutional weaknesses could hinder graduation from MIC to HIC status. At independence, Singapore faced high levels of unemployment and other adverse conditions that SMICs face today. At the heart of Singapore's success story is the concept of a social contract between the ruling People's Action Party government and the people of Singapore, with an emphasis on an effective and efficient governance framework to promote an effective civil service. The government also provided confidence that national policies would remain stable in the short term, while continued efforts were made to enable Singapore to overcome a number of critical challenges. Singapore's economic goal, first and foremost, was to create good jobs for its people by helping businesses take advantage of opportunities. Singaporeans are constantly asking what the market needs, and how they can develop the capabilities to meet these needs. The government also made it possible for both local and international companies to find it worthwhile to establish a presence and invest in Singapore. To remain competitive, they are constantly upgrading those skills and creating a business-friendly environment. Other priorities are security, rule of law, and political stability. Investors need certainty; they need to know what to expect 10 or 20 years from now.

Continuous innovation, including in institution building, is necessary to help support a creative and flexible economy.

Sustained long-term growth requires changes to economic structures over time. The productivity gains from past reforms and cross-sector reallocation might already have peaked and old growth models may have become insufficient. Thus, continuous innovation, sometimes through experimentation, is necessary to survive in a rapidly changing global environment to increase the odds of graduating from MIC status.

Institutional innovation was critical to the export discovery process that led to sustained growth in Chile. For example, Fundación Chile is considered a true institutional innovation that played a major role in the export discovery process (Agosin and Bravo-Ortega 2009). It was established for Chile's salmon industry to find venture capitalists to invest in innovative projects promoting technology transfer and new business models that could benefit the country. The government also initiated an aggressive strategy by negotiating free trade agreements, lowering tariffs, and facilitating access to untapped and larger markets for new exports. The General Directorate for Foreign Economic Affairs and ProChile were in charge of negotiating trade agreements. As of 2014 Chile has trade agreements with 57 countries worldwide, allowing the country to access 86 percent of global GDP.

Malta also managed to use its small open economy characteristics to offer more flexible solutions to its challenges. For example, the government created an agency, Malta Enterprise, that aims to promote industrial development and sustain Malta's competitiveness by creating the enabling environment for enterprises to thrive and continue to innovate.

As noted earlier in the chapter, Singapore's openness to foreign labor and foreign ideas is also an important aspect of the Singapore model. To ensure dynamic movement from low-technology industry to higher-technology industry, and to facilitate the development of a more sophisticated services sector, Singapore demonstrated an openness to absorbing foreign workers and foreign ideas to support a flexible labor market and an economy driven by continuous innovation.

CONCLUSION

The analysis in this introductory chapter presents some of the reasons that SMICs remain in MIC status: (1) the growth that brings a country out of extreme poverty (LIC status), such as, for example, capital deepening, is not always the type of growth that makes a country richer, lifting its per capita income above middle-income levels; (2) they lack the ability to continue the process of moving from low value-added to high value-added industries because the advantages of low-cost labor and imitation of foreign production technology tend to dwindle after middle- and upper-middle-income levels are reached; and (3) they often lack the ability to overcome the political economy constraints to reforms.

Overall, the main message is that a necessary step in avoiding the middle-income trap is to find the policy mix that will unleash productivity, thereby further lifting per capita incomes. Key lessons from MICs that have graduated to advanced economy status show that the steps needed to boost productivity include implementing well-designed and -sequenced policies and reforms that focus on upgrading the human capital base, building the right institutional setting to support an efficient public sector and enhance private sector development and competitiveness, and continuously innovating to help support a creative and flexible economy. However, every country has a unique set of economic, social, cultural, and political economy circumstances, so there is no specific policy mix that will suit all countries.

The rest of this book presents the analytical research that aims to uncover the reform policies that could address the bottlenecks identified in this chapter and support the goal of unlocking the growth potential of SMICs. In doing so, the policies discussed in the book aim to lay out a possible road map to implementation of reforms that could help propel SMICs to advanced economy status.

ANNEX 1.1. FROM EXTREME POVERTY TO MIDDLE-INCOME COUNTRY STATUS—THE CABO VERDE CASE STUDY[12]

At independence in 1975, Cabo Verde's prospects were relatively poor. In particular, the country had

- Virtually no human capital
- Memories of frequent famines
- Only 10 percent of its land suitable for agriculture, out of 4,033 square kilometers
- No resources—even water was scarce due to low rainfall
- Limited domestic markets
- Poor infrastructure
- Scarce educational opportunities—there were only two high schools
- Annual per capita income of about US$190
- No national treasury—Cabo Verde had to appeal to Portugal for US$300,000 to meet current expenses

In fact, many observers (including Cabo Verdeans) did not foresee a future in the islands.

Almost four decades after independence, Cabo Verde's economy has strengthened significantly and its standing looks dramatically different from that of the pre-independence era:

- Annual per capita income increased to about US$3,800
- Poverty fell from 49 percent to about 27 percent

[12] Prepared by Carla Cruz, National Director of Planning at the Ministry of Finance and Economic Planning of Cabo Verde.

- Literacy among youth now stands at about 95 percent
- Infrastructure development stands at fifth in sub-Saharan Africa
- Cabo Verde is among the world's top 10 destinations for foreign direct investment
- Cabo Verde is among the world's top 10 country reformers
- Cabo Verde now ranks fourth in sub-Saharan Africa on the United Nations International Telecommunication Union Information and Communications Technology Development Index
- Cabo Verde now ranks sixth in sub-Saharan Africa on an e-governance index.

Despite this notable progress, several challenges remain, challenges akin to those faced by other SMICs in sub-Saharan Africa:

- During the past two or three decades, growth was driven by several factors: (1) strong investment in education and health in the post-independence era; (2) the process of opening the economy, initiated in the late 1980s; (3) market reforms and privatization in the 1990s; and (4) deep reforms that have been implemented since 2000. These measures were part and parcel of the government's reform agenda, which focuses on maintaining a stable macroeconomic environment and administrative reforms for improving the business environment. Several other relevant factors include, for example, support from the Cabo Verde diaspora, efforts to win the trust of donors since 2001, investment in infrastructure over the past decade, consolidation of democracy, and more foreign direct investment.
- As a largely undiversified and highly open economy, Cabo Verde tends to be vulnerable to global shocks and the associated outward economic spillovers. Thus, Cabo Verde's economy displays a high degree of growth and current account volatility, reflecting concentrated production and export structures that are not broad based. It also still has a large infrastructure gap that it is trying to close with the use of concessional financing that has increased its debt level to close to 100 percent of GDP. This poses particular challenges given the underlying rigidities in the country's fiscal position that limit the use of countercyclical policy actions in the event of shocks. Like other SMICs, growth has moderated somewhat in the past decade and unemployment remains a challenge.

The key lessons from Cabo Verde's development experience thus far include the following:

- Getting the basics right
  - Good governance
  - Macroeconomic stability and credibility and sound management of public finances
  - Investing in people
- Adapting strategies and policies to keep pace with global evolution

- Structural reforms
- Diaspora mobilization policies
- Agenda for economic transformation
- Pioneering electronic governance

- Effective implementation to deliver good economic outcomes
  - State modernization reforms
  - E-governance platform
- Ownership of development priorities facilitated by external aid
  - Donor support group
  - Pilot country for One-UN/Delivering as One
  - Commitment to Paris and Accra Declarations

Carefully calibrated policies to tackle poverty and enhance more inclusive growth include (1) sound economic growth, (2) investment in farming, (3) investment in social programs, and (4) technical and vocational training. The Cabo Verde government also embarked on several reforms of the social security and pension system. Among the reforms that produced positive effects on poverty reduction are the expansion of the minimum social pension to cover new classes of pensioners and the extension of the INPS (social insurance) system to new categories of workers, such as independent professionals and maids. The system already provides broader health insurance to many people, thereby facilitating access to health care. The expansion of the minimum social pension granted the most disadvantaged segments of the population a social security safety net and the conditions for a better life.

During the 2008–09 global financial crisis, the government concentrated on ramping up public investment to counteract the effects of the global slowdown on domestic demand. Seizing the window of opportunity provided by concessional loans made available to Cabo Verde to complete the transition from a least-developed country to a MIC, the government implemented an important investment package; the goal was to overcome some of the constraints to long-term growth, particularly the economic infrastructure. This effort caused the debt to rise; however, because of the government's commitment to macroeconomic stability, the debt level is still considered to be sustainable according to the regular debt-sustainability analysis conducted by the IMF. Additionally, the government has started a strong program of fiscal consolidation, consistent with the long-term reform program, to guarantee that the public accounts will balance and to contribute to increasing competitiveness and promote financial stability.

The agenda for change encompasses a long-term vision for the development of Cabo Verde taking into account its natural advantages—large ocean rights (an 800,000 square kilometer exclusive economic zone), geographic location, and tropical climate. The agenda seeks to lead the country to a modern, predominantly services-based, economy, which would require the development of new sectors of activity to be the drivers of growth, considering the current narrow economic base. Some progress has been achieved, but the challenge lies in accelerating the process of change and reform to trigger new competitive factors to foster the diversification of the economy through clusters of development.

The main vision of the country's development agenda is to be an inclusive nation, fair and prosperous, providing opportunities for all. To meet this goal, the government has identified seven strategic challenges that are intended to be resolved during the legislative session in 2015:

- How to build a dynamic, competitive, and innovative economy, with prosperity for all
- Fostering the private sector, investment, and productivity growth
- Promoting development and social cohesion and facilitating access to basic services
- Capacity building and producing knowledge fostering economic growth
- Consolidating democracy, enhancing freedom, and reinforcing good governance
- Modernizing and expanding infrastructure
- Asserting that Cabo Verde is part of a global world and developing partnerships for competitiveness

The key goal of the new Growth and Poverty Reduction Strategy is to transform Cabo Verde into an international services center supported by a productive base. To make this transformation, Cabo Verde must accelerate, enhance, and expand reforms, which should cover all levels of public administration, including municipalities, agencies, and public companies, with the purpose of building an efficient state, geared toward helping the private sector create jobs and wealth.

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