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Drivers of Growth in Fragile States: Has the HIPC Process Helped Fragile Countries Grow?

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Fragile states – a group of Low Income Countries (LICs) with a score of below 3.2 on the World Bank Country Policy and Institutional Assessment (CPIA) rating – have in common very low per capita income, a poor record of economic growth, predominantly young populations, and rapid rates of population growth.[1] Fragile countries are farthest away from reaching the UN's Millennium Development Goals, with over 300 million poor people living on less than a dollar a day, displaying the highest concentration of extreme poverty and accounting for more than a third of the extreme poor in the world.[2] A majority of fragile states have been affected by wars in recent years, and many remain at a high risk of conflict or political instability. All fragile states have suffered periods of prolonged contraction, usually around the time of conflict and political instability.

Twenty of the 34 identified fragile states, in addition to the characteristics above, are heavily indebted. The Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) have helped qualifying countries reduce extreme external debt burdens, and have contributed to creating fiscal space for channeling resources into poverty-reducing activities and economic development. Fragile HIPCs as a group demonstrate stark differences from the fragile states that are not highly indebted: their income per capita is less than one half that of the non-HIPC fragile states and social indicators across the board are, on average, lower. Their annual economic growth rates remained negative until the mid-1990s, and notably lower than those of non-HIPC fragile states, and total investment growth has been substantially lower and real exchange rate volatility higher than in non-HIPC fragile countries.

Apart from being consistently at the bottom of the fragile states group, the twenty fragile HIPCs are not homogeneous. They are at different stages of the HIPC Initiative: four countries (the Gambia, Mauritania, Sao Tome and Principe, and Sierra Leone) have reached the completion point and received irrevocable HIPC Initiative and MDRI debt relief; ten have reached the decision point and have started to receive interim assistance, and another six have yet to reach the decision point. In addition, three HIPCs that at the time of reaching the HIPC Initiative decision point were fragile states according to the CPIA-based definition (Niger, Cameroon, and Ethiopia), have lost their fragile-state status in the following years.

Does the difference among the various groups of fragile states suggest that there are fundamental differences in the drivers of economic prosperity in these countries? And if so, has the HIPC Initiative process helped countries improve their prospects for growth? The paper aims to explain the economic growth differentials in fragile states and analyze variables that appear to be robust determinants of economic growth in these countries during the last twenty-four years. Using Bayesian Model Averaging (BMA) to assess and identify model uncertainty, we explore the factors affecting the growth of fragile HIPCs and compare them to the robust determinants of income growth both in non-fragile HIPCs and in other non-HIPC fragile countries.

For the group of HIPCs as a whole, our results suggest that physical capital formation and the share of agriculture in production (as measured by agriculture value added) play an important role in explaining growth differences

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1 The CPIA criteria used by Bank staff in assessing the quality of a country's policy and institutional framework include: economic management, structural policies, policies for social inclusion/equity, and public sector management and institutions.
2 See Global Monitoring Report 2008, new benchmarks of extreme poverty.

among these countries. But within that group, fragile HIPCs are heterogeneous in terms of the uncertainty associated with the determinants of their economic growth: none of the variables that appear as robust determinants of economic growth in fragile states or HIPCs are systematically helpful for explaining economic growth differences in the group of fragile HIPCs.

In a second step, the study concentrates on differences between countries within the group of twenty fragile HIPCs, acknowledging the existence of unobservable country-specific characteristics. This analysis reveals that the elasticity of economic growth to physical capital formation in fragile HIPCs tends to be lower than in the rest of HIPCs. Furthermore, the share of agriculture in production tends to be associated with higher growth in fragile HIPCs, suggesting that constraints in subsistence agriculture play a particularly important role in fragile states. There is robust evidence of income convergence in the full group of HIPCs, as well as within the group fragile HIPCs. But fragile HIPCs present a lower speed of conditional income convergence to their country-specific long run equilibrium level as compared with non-fragile HIPCs. Compared to both fragile non-HIPC countries and to non-fragile HIPCs, the reduction in economic growth rates implied by armed conflict is highest in fragile HIPCs.

In sum, the results on the determinants of the economic growth process in fragile states indicates that fragility has hindered countries' progress through the HIPC Initiative process. In comparison with non-fragile HIPCs, fragile HIPCs have suffered from the highest reduction in economic growth inflicted by armed conflict; have had the lowest volume of investment and returns to it; and are slowest in converging to their long-run equilibrium level. Nonetheless, growth rates in fragile HIPCs that have passed the completion point have on average been faster than in other groups of fragile states, suggesting some positive association between debt relief and economic development. While we do not find a direct link between the reduction in debt burdens and GDP growth, we find evidence concerning the importance of institutional quality in countries with decreasing debt levels. This finding implies that improvements in the institutional setting are a major necessity for debt relief to materialize itself in higher growth rates of income. In addition, the results indicate that the HIPC process may help fragile countries to both improve the quality of policies and institutions and, subsequently, achieve higher growth.