UNCTAD's Least Developed Countries Report 2006

Developing Productive Capacities
RECENT GDP GROWTH PERFORMANCE HAS BEEN GOOD

• In 2004 **real GDP** of the LDCs as a group grew by 5.9 per cent (the highest for two decades).
• **Exports** reached a record level (US$57.8 billion merchandise exports).
• **FDI inflows** reached a record level (US$10.7 billion).
• **ODA inflows** reached a record level (US$24.9 billion).
BUT THREE MAJOR CONCERNS

• Some LDCs are still be left out. Real GDP per capita declined or stagnated in one-third of the LDCs in 2004.

• Sustainability. "The sustainability of growth is fragile as it is highly dependent on trends in commodity prices, including oil prices, trends in external finance, preferences for exports of manufactured goods, and climatic and weather conditions".

• Effectiveness of Poverty Impact.
IN A LONG-TERM PERSPECTIVE...

• LDCs have been very vulnerable to economic crises and growth collapses.

• After political Independence, only 7 out of 40 LDCs for which data are available experienced steady growth (Bangladesh, Bhutan, Burkina Faso, Cape Verde, Lao PDR, Lesotho and Nepal).

• Of the 33 LDCs which have experienced major output losses, there are only 12 whose GDP per capita is now higher than it was at its peak in the 1970s and early 1980s.

• 21 out of 40 LDCs have experienced severe growth collapses.
In long-term perspective, GDP per capita of most LDCs is **diverging** from rich countries (1980-2003)

- **Converging economies** (average annual GDP per capita growth more than 2.15 per cent): Bangladesh, Bhutan, Cape Verde, Equatorial Guinea, Lao PDR, Lesotho, Mozambique, Nepal, Uganda.

- **Weak-growth economies** (positive GDP per capita growth but less than 2.15 per cent per annum): Benin, Burkina Faso, Chad, Ethiopia, Guinea, Kiribati, Malawi, Mali, Mauritania, Samoa, Senegal, Solomon Islands, Sudan, Tanzania, Vanuatu.

ALSO: Economic Growth is NOT translating effectively into poverty reduction and improved human well-being

- This issue was considered in UNCTAD's LDC Report 2004: Linking International Trade with Poverty Reduction.
- The evidence shows that there have been significant export take-offs in a large number of LDCs but export growth is not having a strong and sustained poverty-reduction effect in most of them.
- Export activities often exist as enclave sectors with weak links to the rest of the economy.
THE BASIC ARGUMENT

The development and utilization of productive capacities should be placed at the heart of national and international policies to promote sustained economic growth and poverty reduction in the LDCs.
WHAT ARE PRODUCTIVE CAPACITIES?

• Productive **resources** – natural resources, human resources, financial capital, physical capital.

• Entrepreneurial **capabilities** – core competences; technological capabilities.

• Production **linkages** – exchange of goods and services; flows of information; human and financial resource flows – between sectors and between enterprises.
The Definition Used in the Report

• "Productive capacities are the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop". (UNCTAD's Least Developed Countries Report 2006: p. 61).
Chart 9. How productive capacities develop

Global integration
- Trade
- Technology
- Knowledge
- Finance
- People

Productive capacities
- Capital accumulation
- Technological progress
- Structural change

Institutions
- National
  - States
  - Markets
  - Firms
  - Financial systems
  - Knowledge systems
- International
  International and regional regimes for:
  - Trade
  - Finance
  - Intellectual property
  - Technology
  - Migration
  - Labour

Demand
- Net exports
- Consumption
- Investment
Utilization of Productive Capacities Matters as well as Development

- Productive capacities create only a potential for production and growth. Whether this potential is realized depends on whether they are fully used.
- Whether they are fully used depends on demand-side factors.
- In most LDCs, there are underutilized productive resources and entrepreneurial capabilities.
- Including: underemployed labour; latent entrepreneurial capabilities; unmobilized savings; untapped natural resources.
Chart 11. The relationship between economic growth, productive capacities and poverty reduction

- Increased consumption demand
- Entrepreneurship
- Human development

Economic growth

Demand-side stimulus

Development and utilization of productive capacities

Relaxation of supply-side constraints

Poverty reduction

- Expansion of productive employment
- Lower prices of wage goods
- Improved public services
- Better governance
Weak Poverty Reduction Effects are related to Weak Development of Productive Capacities

- In almost all LDCs, there is an imbalance between the rate of growth of the labour force, which is very rapid owing to high population growth rates, and the rate of growth of capital accumulation and technological progress, which is generally very slow.

- Labour productivity is low and there is widespread underemployment.

- This is the basic cause of persistent mass poverty in most LDCs.
MOST LDCs FACE AN EMPLOYMENT CRISIS WHICH IS DEEPENING

• With population growth, agricultural farm sizes are declining and farms are more located on marginal land.
• Mass poverty means that many cannot afford the means for sustainable intensification of agricultural production.
• More and more people are seeking work outside agriculture and urbanization is accelerating.
• Most LDCs have not been able to generate sufficient productive off-farm jobs to absorb the growing labour force seeking work outside agriculture.
• Both agriculture and non-agricultural enterprises are severely challenged to compete following widespread and deep unilateral trade liberalization since the 1990s.
### Dimensions of the Employment Challenge

#### (1) Numbers

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>2000</th>
<th>2010</th>
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<tbody>
<tr>
<td>Size of LDC labor force (million)</td>
<td>242</td>
<td>312</td>
<td>401</td>
</tr>
<tr>
<td>in non-agriculture (% total)</td>
<td>24</td>
<td>29</td>
<td>35</td>
</tr>
<tr>
<td>in urban areas (% total)</td>
<td>21</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>Increase of labor force (million)</td>
<td>51</td>
<td>71</td>
<td>88</td>
</tr>
<tr>
<td>in agriculture (million)</td>
<td>32</td>
<td>37</td>
<td>39</td>
</tr>
<tr>
<td>in non-agriculture (million)</td>
<td>19</td>
<td>34</td>
<td>49</td>
</tr>
</tbody>
</table>
Dimensions of the Employment Challenge
(2) Productivity

**Chart 23. Change of agricultural, non-agricultural and economy-wide labour productivity in LDCs, other developing countries and developed countries, 1983–2003**

A. Agricultural labour productivity

B. Non-agricultural labour productivity

C. Economy-wide labour productivity


**Note:** Group of other developing countries includes 67 countries; group of developed countries includes 22 countries; averages are weighted.

Indices are calculated based on data in constant 2000 dollars.

Labour productivity is ratio of value-added and economically-active population in respective sectors.
Dimensions of the Employment Challenge
(3) Some Facts and Figures

- In 2000-2003, agricultural labour productivity was lower than 20 years earlier in one-thirds of the LDCs.
- In 2000-2003, non-agricultural labour productivity was lower than 20 years earlier in four-fifths of the LDCs.
- In 2000-2003, it required five workers in LDCs to produce what one worker produced in other developing countries, and 94 LDC workers to match the productivity of one worker in a developed country.
- In 2000-2003, agricultural labour productivity was just 46 per cent of the level in other developing countries and less than 1 per cent of the level in developed countries.
- In 2000-2003, agricultural land per agricultural worker was less than 1 hectare in 33 out of 50 LDCs.
- 70-80 per cent of non-agricultural employment in LDCs in informal sector enterprises
EXAMPLE: Urban Unemployment and Underemployment in Weak-Growth Economies

Based on Cotonou (Benin), Ougadougou (Burkina Faso), Bamako (Mali), Dakar (Senegal) 2000-2001

1. Unemployment: ILO definition
2. Unemployment: ILO + discouraged workers
3. Visible underemployment: Less than 35 hours per week
4. Invisible underemployment: Incomes less than national minimum wage ("working poor")
5. Unemployment + invisible underemployment as % of economically active population
How strong are the processes through which productive capacities develop in the LDCs?

(1) **Capital Accumulation**

- Capital formation as % of GDP is increasing. 22 per cent in 1999-2003; 5 percentage points higher than ten years earlier.
- Domestic private investment remains weak generally.
- Increasing proportion of capital formation financed by domestic savings (14 per cent 1999-2003).
- BUT domestic savings rate too low to support positive economic growth without resort to external finance.
- External finance supported 40 per cent of capital formation in the LDCs (1 per cent in other developing countries).
- Adjusting for natural resource depletion and ODA grants, genuine national savings were negative for LDCs as a group during 2000-2003.
Weak human capital formation and brain drain

- The average years of schooling of the adult population in LDCs in 2000 was 3 years, the same as the level in other developing countries in 1960.
- Tertiary enrolment rates in LDCs are much lower than in other developing countries, especially in engineering.
- About one in five of the high-skill workers (persons with 13 years schooling and above) were working in OECD countries in 2000.
- The intensity of the brain drain from African and Asian LDCs increased significantly in the 1990s.
How strong are the processes through which productive capacities develop in the LDCs?

(2) Structural Change

- For the LDCs as a group, there has been little change in the production structure since the early 1980s.
- Share of agriculture in GDP declining slowly whilst share of industry and services rising slowly.
- Much of the increase in industrial value-added concentrated in a few countries and based on mining industries, oil and generation of hydroelectric power.
- Services expansion fastest in petty trade and commercial services.
- Between 1990-1993 and 2000-2003 manufacturing value-added declined as a share of GDP in 19 out of 36 LDCs and stagnated in a further two.
Manufacturing industrialization and de-industrialization
Important differences amongst the LDCs:

<table>
<thead>
<tr>
<th></th>
<th>Converging economies</th>
<th>Weak-growth economies</th>
<th>Regressing economies</th>
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<tbody>
<tr>
<td>Agriculture/ GDP</td>
<td>— —</td>
<td>+</td>
<td>++</td>
</tr>
<tr>
<td>Industry/ GDP</td>
<td>+ +</td>
<td>+</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Manufacturing</td>
<td>+</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Non-manufacturing</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Services/ GDP</td>
<td>+</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Agricultural labor productivity</td>
<td>+</td>
<td>+</td>
<td>—</td>
</tr>
<tr>
<td>Non-agricultural labor productivity</td>
<td>+</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total labor productivity</td>
<td>+</td>
<td>+</td>
<td>—</td>
</tr>
</tbody>
</table>
How strong are the processes through which productive capacities develop in the LDCs?

(3) Technological Learning

• Traditional indicators of technological effort (R&D expenditure, patents, numbers of scientists and researchers, sci. publications) show that LDCs seriously lag behind other developing countries (table 36)

• These indicators are not fully representative for very poor countries

• Firm-level Investment Climate Surveys (World Bank) show new machinery and equipment is the most important channel of technological acquisition in the LDCs

• In real terms machinery and equipment imports per capita into LDCs during 2000-2003 were at almost the same level as 1980

• Seven times lower than into other developing countries.
Differences amongst LDCs grouped according to long-term growth performance are less

- There is a sharp fall in machinery and equipment imports (in real per capita terms and as share of GDP) in the **regressing economies**.
- Machinery and equipment imports in the **converging economies** stagnate (same in 2003 as 1984).
- Machinery and equipment imports in the **weak-growth economies** rise (related to FDI?).
- Share of medium and high-tech manufactures in total merchandise exports also only growing slowly in **converging economies**.
Implications for Trade Integration

- **EXPORTS.** "The goods and services which the LDCs can supply competitively to world markets are ultimately limited by the goods and services which they can produce and how efficiently they are at producing them".
- Weak productive capacities are the basic source of marginalization of LDCs in world trade and also the heavy reliance of the export structure on exploitation of natural resources.
- LDC share of world exports (goods+services) 0.5 per cent in 2000-2003 (11 per cent of world population).
- **IMPORTS.** Net food imports have been increasing in the 1990s and this trend has accelerated since 2000 in African LDCs.
What Are the Key Constraints and Policy Priorities?

• These are country-specific but the Report identifies three broad areas which are likely to applicable in many LDCs…

• Weak Physical **Infrastructure**

• **Institutions**: Weak Domestic Private Sector and Domestic Financial and Knowledge Systems

• **Demand** Constraints
LDCs have the worst infrastructure in the world
There is a major electricity divide
Policies to Close the Infrastructure Divide

(1) Finance

- Increased public investment and ODA in physical infrastructure.
- Major financing gap: ODA commitments for economic infrastructure and private capital inflows for energy, telecommunications and transport to LDCs amounted to 0.7 per cent of GDP in 2004; but annual infrastructure investment (including water and sanitation) equivalent to 7.5 – 9 per cent of GDP.
Policies to Close the Infrastructure Divide

(2) Priorities

- **Trade-related infrastructure** alone is **not enough** (export growth but not economy-wide poverty reduction).
- Best approach is a "**joined-up**" approach to infrastructure investment three elements:
  - (1) **Rural infrastructure** (vital for agrarian commercialization and productivity growth and development of off-farm activities).
  - (2) **Large-scale national infrastructure** (enables structural transformation, exercise of entrepreneurial capabilities and development of production linkages).
  - (3) **Cross-border infrastructure** (for regional trade).
- **Closing the electricity divide** is as significant for economic growth and poverty reduction as closing the digital divide.
Institutions

• Governance matters but …
• The focus on weak state capacities is ignoring weak domestic private sector capacities related to …
  • Lack of domestic firms (the "missing middle")
  • Weak domestic financial systems
  • Weak domestic knowledge systems
• "A private sector led approach which does not pay attention to the nature of the private sector will inevitably fail in very poor countries."
The "Missing Middle" (MM)

- MM refers to the weak development of formal sector SMEs, particularly medium-sized domestic enterprises.
- Typically informal sector enterprises do not develop into formal sector firms and small firms do not grow into large firms.
- Investment climate reforms (to reduce red tape and costs of doing business) are not enough in a context of radical firm heterogeneity and structural heterogeneity in LDCs.
- Need to foster the development of domestic medium-sized firms and production linkages.
Improving domestic financial systems is a key policy lever for enterprise development.
Improving domestic knowledge systems is a key policy lever for enterprise development

- Domestic Knowledge Systems (DKS) refer to "the set of institutions within a country which enable (or constrain) the creation, use and sharing of knowledge".
- Current problems: disarticulation between traditional and modern knowledge systems; modern knowledge systems (universities, national research institutes, etc.) are not functioning as an integrated system, not demand-driven, not well-integrated internationally.
- Develop national technology learning strategies to increase access to/effective use of foreign technology.
- Blend modern and traditional knowledge.
- Create linking institutions.
The crucial role of effective demand

- Increased public investment and ODA to improve physical infrastructure will not work without policies to address domestic private sector weaknesses.
- Both these supply-side policies will not work unless there is effective demand.
- Demand stimulus provides the inducement for investment, technological learning and innovation
- If there is lack of effective demand, existing productive capacities will be underutilized.
Policies to Address the Demand Constraint

• Need to address dynamics of domestic demand as well as international competitiveness and access to international markets.
• Sluggish domestic demand must be identified as a central deficiency of the investment climate in the LDCs.
• For domestic markets – agricultural productivity growth and linkages to local manufacturing and services are critical (non-tradables are key to broad-based poverty reduction).
• The demand-side contribution of exports has been seriously reduced by declining terms of trade and currency depreciation.
• For exports – focus on upgrading the export structure towards more dynamic products.
Focusing on the Development and Utilization of Productive Capacities Requires a Paradigm Shift in Poverty Reduction Policies

FROM
- Integration/Exchange
- Consumption
- Framework
- Supply-side
- Tradables
- FDI
- Welfare State

TO
- Production
- Employment
- Ingredients
- Supply and Demand
- Tradables and Non-tradables
- Private Domestic Investment plus FDI
- Development State
Design of National Poverty Reduction Strategies

• Weak development of productive capacities was a major key weakness of 1st-generation reforms [World Bank (2005) Econ. Growth in the 1990s: Lessons from a Decade of Reform].

• Poverty Reduction Strategies: production sectors weakly integrated; stronger focus on social sectors.

• Approach to improving the Investment Climate limited.

• Focus on exports and FDI; too little attention on domestic private investment, domestic markets, underutilized domestic resources/capabilities.

• Institutions - Emphasis on governance and neglect of the nature of domestic private sector.
Improving the Investment Climate: How?

• Current approach shrinks the notion of the investment climate (IC): (i) IC=government policies and regulations; (ii) less govt.=better IC.
• BUT weak domestic demand is a crucial aspect of a bad investment climate in LDCs.
• Pro-active public policies necessary to induce and coordinate private investment.
• Given firm heterogeneity and persistent productivity gaps, the economy-wide incentive framework is not enough.
• ALSO: need to build domestic enterprise capabilities at micro-level and promote dynamic inter-sectoral linkages.
Are Current International Policies Adequate?

- Aid is being scaled up but it will be ineffective if it is linked to the wrong development model (only direct welfare improvement without developing productive capacities).
- Sectoral composition of aid (see next slide).
- Special international support measures for LDCs are more oriented towards market access than developing productive capacities.
- "Aid for trade", if it develops export supply capacities, is a move in the right direction. But it is a narrow approach to developing productive capacities.
Some Recent Aid Trends

• In nominal terms, net ODA to LDCs **doubled** between 1999 and 2004 but …

• In 2004, 46.5 per cent went to debt forgiveness grants, emergency aid, technical assistance and development food aid.

• Sectoral composition of aid has been shifting **against production**: share of ODA to economic infrastructure and productive sectors declining. 48% of aid commitments in 1992-1994, 32% in 1999-2001, and 24% in 2002-2004.

• Approaches to "MDG-based"/"poverty-focused" aid which are narrowly target-focused could exacerbate this trend.

• **In real per capita terms**, net ODA to LDCs was 13.5 per cent lower in 2000-2004 than 10 years earlier.
International Support Measures for LDCs

• Increase share of aid for in-country programmes and direct support for programmes run by LDC governments.
• Re-balance the sectoral composition of aid towards production.
• Beyond trade preferences.
• There is a need for international policy innovation to support the development and full utilization of productive capacities in the LDCs.
Thank You