UN-OHRLLS

Promotion of Structural Economic Transformation, Diversification and Value-Addition in LLDCs

Background note

Session 2

Ministerial Meeting of LLDCs on Trade and Transport

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1. Introduction

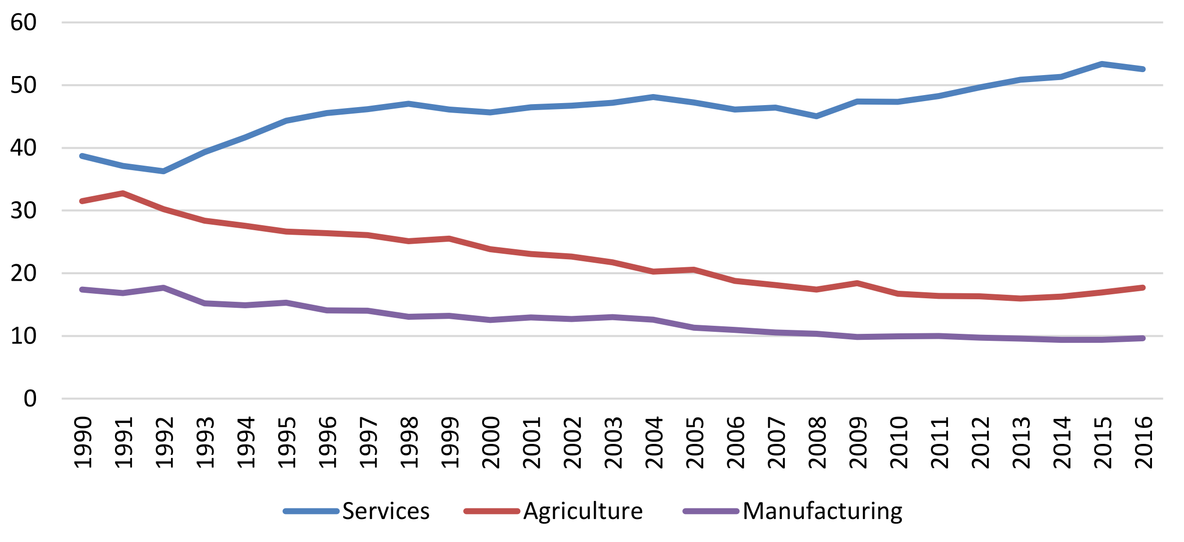
Structural economic transformation can be identified as relocation of resources from low- to high-productivity sectors, often involving industrial development. Structural economic transformation can dramatically increase the income levels of poor countries, supporting poverty eradication and sustained economic growth. Historically, as countries structurally transform, the demand for manufactured products rises, the share of employment in agriculture declines and employment in industry or urban-based services rises, accompanied by productivity increases. Then, as services become more prevalent with rising incomes, the share of manufacturing and agriculture tends to fall while share of the services sector rises, sustaining countries' economic growth.

Undergoing structural transformation is important for all developing countries if sustained economic growth and poverty eradication are to be achieved. For LLDCs, which remain reliant on a few export commodities, structural transformation, diversification and value-addition is essential for successfully integrating into the global economy, reducing the negative impacts of landlockedness and external shocks.

2. Trends in value-addition and industrialization in LLDCs

In the 1990s, the value-added share of manufacturing in GDP of LLDCs declined from 17.4% in 1990 to 12.6% in 2000 (Figure 1). Between 2003 and 2013, the share was on average 10.7% in the LLDCs, declining to 9.5% in 2014-2016. Since 2003, only five LLDCs experienced an increase in their manufacturing share in GDP. The value-added share of agriculture in GDP also declined in the LLDCs, from a high of 32.8% in early 1990s, to a low of 16% in 2013, before rising slightly to 17% in 2016. In contrast, the value-added share of services in GDP increased significantly from 38.7% in 1990 to 45.7% in 2000 and 52.5% in 2016.

Figure 1: Value-added share of sectors in economic activity in LLDCs (percentage of GDP)



Source: World Bank World Development Indicators

This indicates that LLDCs are experiencing premature de-industrialization. Their share of manufacturing seems to have peaked at an earlier stage in their development than today's advanced economies, removing the main channel through which productivity benefits and rapid growth have taken place in the past. Their limited level of industrialization can also be observed in the low share of employment in industry, which the International Labour Organization estimates to be 11%, as compared to 21% in developing countries overall. The fact that agriculture accounts for around 50% of employment in the LLDCs, according to the FAO, but its value-added share in the economy is less than 20% suggests low relative levels of productivity of agriculture in the LLDCs in comparison to the other sectors. Additionally, the productivity of the LLDC agricultural sector has not since 2000 converged to the levels of OECD countries.

According to UNIDO's Competitive Industrial Performance (CIP) index[1], which depicts a country's overall measures of industrial performance, 11 LLDCs ranked in the bottom fifth of the rankings in 2015. Furthermore, none of the LLDCs ranked in the two top quintiles but four ranked in the middle quintile (Kazakhstan, Macedonia, Swaziland and Botswana). Between 2010 and 2015, two LLDCs improved their rankings to move to higher quintile: Botswana—from the lower-middle to the middle quintile and the Republic of Moldova—from the bottom to the lower-middle quintile.

The data also suggests that LLDCs' combined impact on world manufacturing is negligible. As measured by their share of world manufacturing value added and world manufacturing trade, LLDCs accounted for only 0.39% and 0.31%, respectively. This suggests that LLDCs have very limited capacity to produce and export manufactured goods.

3. Progress in diversification of LLDC exports

This phenomenon can also be observed in the declining share of manufacturing goods in total LLDCs' merchandise exports (Figure 2). The share gradually fell from 24% in 1995 to 12% in 2013. Since then, an increase to 17.5% in 2016 can be observed and the share of manufactured goods increased in 20 LLDCs.

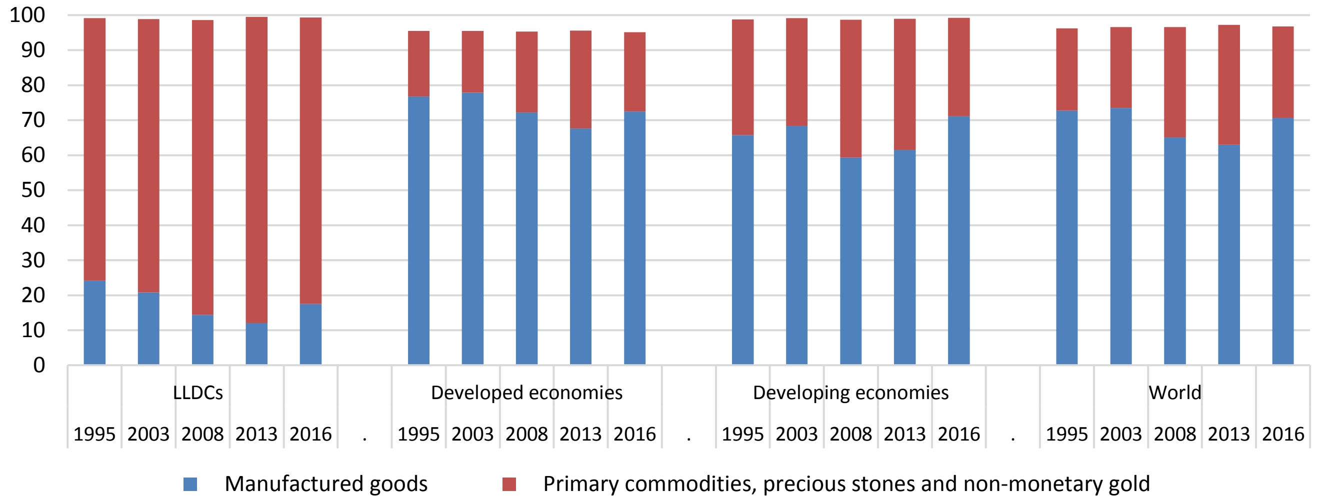
In comparison however, the share for developing countries stood at 71.1%, with only one LLDC (Macedonia) exceeding this. At the same time, the share of primary commodities, precious stones and non-monetary gold in LLDCs' exports, while decreasing in recent years likely due to falls in commodity prices, remains high at 81.9%. In comparison, these products account for only around 18% of exports of developing countries and 26% of world exports, showcasing LLDCs' dependence on primary commodities, which have low value-addition.

Not only are LLDC exports focused on primary commodities, they are also concentrated in a limited number of products. LLDC exports became more concentrated in a fewer products in the 2000s, as measured by the concentration index (Herfindahl-Hirschmann Index)[2], which reached a high of 0.38 in 2013. Since then, the index has fallen to 0.22 in 2016, but it is still considerably higher than the 0.09 reported for developing countries. At the same time, the diversification index[3], which measures the deviation of the trade structure from the world structure, has remained at

[1] The latest 2015 CIP ranking includes 148 economies, including 22 LLDCs.
[2] A value closer to 1 indicates a country's exports or imports are highly concentrated on a few products.
[3] A value closer to 1 indicates greater divergence from the world pattern.

around 0.63 since 1995 and even slightly increased in 2014-2016 to 0.65. In contrast, developing countries as a whole had a diversification index of 0.2 in 2016, and this has fallen from 0.27 in the late 1990s and early 2000s. This indicates that the trade structure of LLDCs has not become more diversified, in comparison to the global average.

Figure 2: Share of primary commodities and manufactured goods in exports (percentage)



Source: UNCTADStat

High concentration of exports in a few products, in particular raw primary commodities with low value addition, makes LLDCs vulnerable to external shocks and limits their competitiveness, compared to other countries. The World Economic Forum's Global Competitiveness Index[4], which assesses the competitiveness landscape across countries, ranked four LLDCs in top half (second quarter) of the countries examined in the 2017-2018 edition. But at the same time, 11 LLDCs ranked in the bottom quarter.

4. Supportive business environment and the role of business

Country's ability to develop an industrial base is reliant on the business environment. Data from the World Bank's Doing Business database compare 190 countries in the ease of doing business, with high ease of business indicating that the regulatory environment in a country is more conducive to the starting and operation of a local firm. The data indicates that majority of LLDCs have shown improvements in their regulatory environment for the local private sector, pointing to improvements in their economies. Between 2009 and 2013, all of the LLDCs experienced improvements in their regulatory environment, but since 2013, 10 LLDCs have experienced setbacks in their regulatory reform efforts.

In 2016/2017[5], one LLDC, Macedonia, ranked in the top 20 countries in terms of their business regulatory environment and with 41 business regulation reforms, has carried out the second highest number of reforms among the top 20 since 2003. Three more LLDCs also ranked in the top quarter of the countries. At the same time, 19 LLDCs ranked in the bottom two quarters of the rankings.

[4] The 2017-2018 edition of the index has information available for 137 countries, 23 of which are LLDCs.
[5] From 2 June 2016 to 1 June 2017.

In addition, the 2018 edition of Doing Business also identifies countries that implemented regulatory reforms in 2016/17 making it easier to do business in three or more of the 10 areas covered. Amongst the 23 economies, there were 8 LLDCs and 3 of these (Malawi, Uzbekistan and Zambia) were on the list of the top 10 improvers. This is indicative of these economies undertaking ongoing, broad-based reform programs.

The structural economic challenges faced by LLDCs can be addressed more effectively with the participation of business. While the value of domestic credit provided to the private sector in LLDCs by financial corporations has increased from an average of 19% of GDP in 2000 to 35% in 2016, LLDCs still lag greatly behind other developing countries in this regard. For developing countries as a whole, the value is close to 100%. According to World Bank Enterprise Surveys, on average, 30% of LLDC firms identify access to finance as a major constraint. Since public sector funds in the LLDCs are limited, the private sector needs to be strengthened and supported, in particular SMEs.

Examples of LLDC efforts to diversify and transform their economies

Several LLDCs are making efforts to diversify and transform their economies. For example, Uzbekistan attempts to follow import-substitution industrialization focused initially on labour intensive industries with a gradual increase in their technology intensity. Kazakhstan's development targeting is currently aimed, among others, at transport services, energy efficiency and agriculture. Mongolia's National Development Strategy 2030 targets agriculture, tourism, energy and industrial materials processing as priority sectors for economic development. Kyrgyzstan's economic diversification includes developing textile industry. Lao PDR saw the establishment of many new manufacturing firms in Lao PDR's special economic zones, with the cooperation of China. The key objective of the national development plan of Ethiopia is bringing about a structural change in the economy by broadening the industrial base, supporting small and medium-sized enterprises, increasing productivity and strengthening linkages among industries. Botswana is undertaking reforms to promote the development of services, industry, tourism and agriculture.

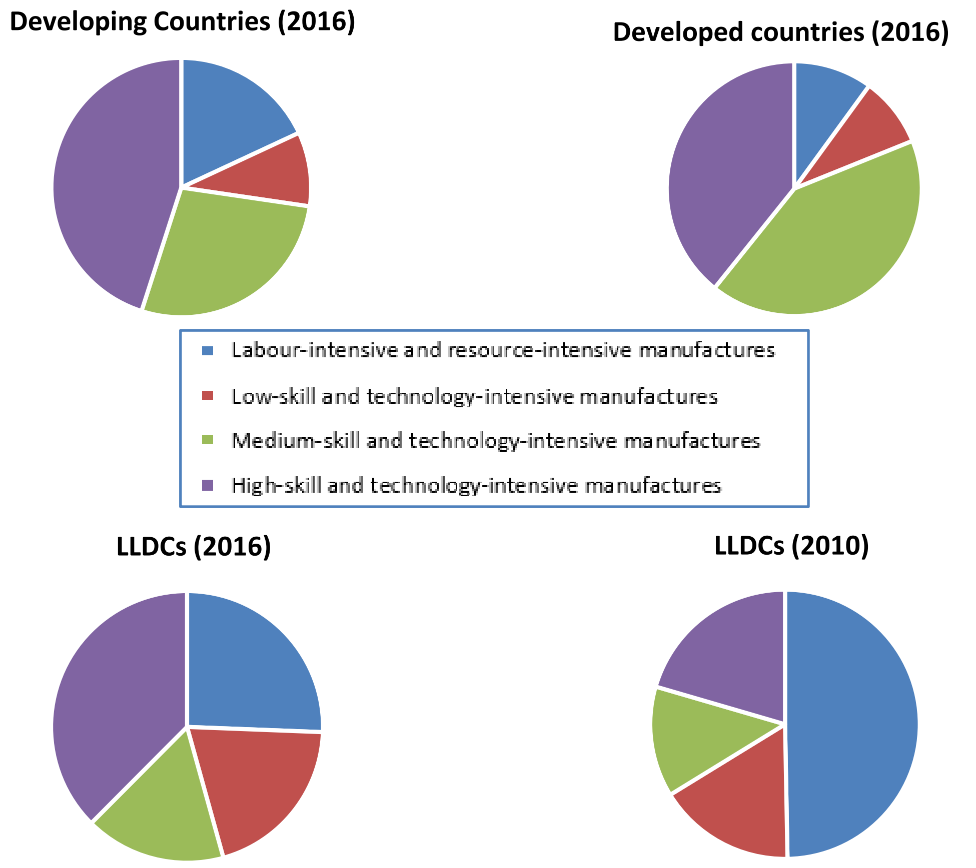
Source: National reports submitted for the preparation of the 2017 Report of the UN Secretary-General on implementation of the VPoA

5. Opportunities for enhancing structural economic transformation in LLDCs

In order to foster structural economic transformation, LLDCs should strive to shift productive resources away from low-productivity sectors such as agriculture and commodity extraction towards modern higher value added and high-productivity sectors, such as manufacturing and technologically sophisticated production. In LLDCs where agriculture accounts for large proportion of employment and remains a major contributor to GDP, in particular in African and several Asian LLDCs, efforts should be made to raise agricultural productivity and industrialize agriculture, including through employing industrial production methods and expanding value chains for agri-business and agro-processing. New efforts in promoting agricultural trade and facilitating climate resilience agriculture products are also important for the economic diversification of LLDCs.

Adding value to their products can be achieved with greater use of modern technology. However, utilizing technology in the production of manufactured products is an area where LLDCs are still facing some challenges. According to World Bank data, the high-technology content of manufactured exports was below 10% of manufactured exports in 16 of the 20 LLDCs where data is available for 2015-2016. In contrast, this share amounts to around 19% for high and middle-income countries. According to UNCTAD data, LLDCs lag behind in technology-intensive manufactures exports compared to developing countries and in particular developed countries (Figure 3). However, the data also indicates that LLDCs as a group made a large leap in employing skill and technology in the production of their manufactures since early 2000s. They have moved away from labour-intensive and resource-intensive manufactures, whose share in manufactured products has almost halved since 2000. In contrast, the share of high-skill and technology-intensive manufactures has increased by 83% by 2016.

Figure 3: Resource-intensive versus technology-intensive manufactures exports



Source: UNCTADStat

The services sector also presents another opportunity for the LLDCs to diversify their economies. Given the geographical obstacles, remoteness and isolation from markets, high transit costs and inadequate trade and investment, tourism is increasingly being recognized as an important sector for the LLDCs in creating entrepreneurship opportunities as well as full and productive employment and decent work for all and providing a platform to foster economic growth. The development of airline routes and sustaining their economic viability through tourism also contributes to diversifying market access for various economic activities of LLDCs.

Aim of the Session: *The session will discuss and share experiences on the progress that the LLDCs have made on structural transformation, diversification and value-addition. It will identify the challenges, opportunities and best practices and suggest recommendations to foster structural transformation.*

Issues and Questions for Discussion:

1. *What are the LLDCs' experiences on structural transformation? What can the LLDCs learn from other countries' experience; in terms of achievements, as well as challenges with structural reforms, value addition in the industrial and services sectors and attracting investment?*
2. *How can LLDCs foster inclusive and sustainable industrialization that drives structural change and economic growth and what is the role of effective industrial policies? How can improved infrastructure development foster industrialization in LLDCs?*
3. *What have been the challenges and what can the LLDCs learn from the process of structural transformation from across the different regions – Africa, Asia, Europe and Latin America?*
4. *How can LLDCs diversify and add value to their products and exports as part of their structural reforms? What have been the trends in LLDCs in this regard and what are the challenges and opportunities?*
5. *How can LLDCs create and sustain competitive industries, encourage value-addition and promote deeper integration into the global economy? What kind of support do they need from their development partners?*