UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE LEAST DEVELOPED COUNTRIES 2000 REPORT

OVERVIEW
by the Secretary-General of UNCTAD

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Overview

A Constructive New Beginning or Business as Usual?

In the early 1990s, there was a widespread expectation that the globalization of production systems and of finance, and the liberalization of economic activity, would promote diminishing income disparities between countries within the global economy. For the least developed countries, the prospect that the removal of legal and political obstacles to trade and capital movements would lead to accelerated growth and income convergence with more advanced countries was particularly inviting. During the 1990s there has been an accelerating process of economic liberalization in many least developed countries (LDCs). However, overall progress in increasing real incomes, reducing poverty and moving towards various international targets for human and social development has been disappointingly slow, except for a few of them.

A radical rethinking of international development cooperation, of profound significance for the LDCs, is currently under way. At the multilateral level, the IMF has undertaken two major evaluations of its lending operations for low-income countries. On the basis of their findings it has transformed its Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility (PRGF), and is now attempting to re-engineer the way it operates in poor countries. The World Bank has similarly conducted in-depth evaluations of its experience with adjustment lending. Adjustment policies have now been pursued in many poor countries for as many years as the earlier import substitution industrialization policies, and the World Bank has sought to create a new development paradigm which draws on the lessons of both periods. The new paradigm is embodied in its Comprehensive Development Framework and elements of this are now being put into practice by making poverty reduction strategies the basis for concessional lending to low-income countries through the IDA, and debt relief to highly indebted poor countries. Furthermore, the OECD has thoroughly reassessed the effectiveness of bilateral development assistance, and made comprehensive proposals for improving development cooperation through application of the principles of partnership and policy coherence. Its report, *Shaping the 21st Century: The Contribution of Development Co-operation*, has stimulated reflection and innovation in bilateral aid policies in many donor countries.

This rethinking is a response to two major trends of the 1990s. The first comprises globalization and liberalization. The second is the uneven distribution of the costs and benefits of these processes. The number of people living in poverty is increasing in various regions of the world, and the poorest countries are failing to catch up with developed and other developing countries, and some are getting stuck in vicious circles of economic stagnation and regress.

The group of least developed countries contain the hard core of the problem of marginalization in the world economy. A new approach to international development cooperation is essential if this situation is to be rectified, and it is for this reason that the current rethinking is so important for the LDCs. However, it is vital that the new approach should actually be a constructive new beginning rather than business as usual. Some preliminary assessments of the changes being made suggest that these are symbolic rather than substantial, but this Report does not subscribe to that point of view. There are serious changes being made in international development cooperation. But it is debatable whether they are wholly right. The new approach is still in the making, and the central question which both LDCs and their development partners must therefore keep in the forefront is, “Why should we expect better results this time around?”. Moreover, the central disposition which they must cultivate as they construct the new approach is, "How can we ensure that we achieve better results this time around?".

For the 614 million people currently living in LDCs, the stakes are high. If the average growth rate of real GDP per capita achieved by individual LDCs in the period 1990–1998 continues into the future, only one out of the 43 LDCs whose GDP per capita is below $900 - which is currently one of the criteria for graduation from the category of LDC - will reach that threshold before the end of 2015, and only eight countries will reach it in the next 50 years. An increasing number of the 22 LDCs where real GDP per capita either declined or was stagnant during the period 1990–1998 can be expected to become caught in a situation in which economic regress, social stress and political instability interact in a vicious circle. Even for those LDCs which are growing, there will be an ever-present danger that external shocks, natural disasters, or negative spillover effects from neighbouring LDCs, will disrupt economic activity and throw them off their fragile growth trajectories. In this scenario, the LDCs will become pockets of persistent poverty in the global economy. Moreover, with continued international commitment to a two speed liberal economic order, in which policies to facilitate the free movement of goods and capital are vigorously pursued whilst equivalent measures to facilitate the free movement of labour are discouraged, the citizens of LDCs will increasingly face an unenviable choice between either poverty at home, or social exclusion abroad, as illegal workers or second-class citizens in other countries.

If, on the other hand, a new approach to international cooperation creates an appropriate international enabling environment and fosters more effective national development policies, it is possible to envisage an economic take-off occurring in an increasing number of countries and their graduation from the LDC category. According to this scenario, there will be a progressive transition in which sustainable growth is increasingly founded on domestic resource mobilization, the attraction of developmental FDI and the tapping of international financial markets, while vulnerability to shocks, and to associated social stress, declines.

The opportunity of UNLDC III

This Report has been prepared with a view to the Third United Nations Conference on the Least Developed Countries (UNLDC III), which will be held at Brussels in May 2001. UNLDC III will be an important forum in which the special problems of the least developed countries are brought into prominence in the hope that changes in international cooperation adequately address their development needs. The Conference will be a major opportunity for the LDCs and their development partners to devise practical mechanisms of partnership and policy coherence. This Report is intended as an input to those discussions. It aims to provide a better substantive basis for an approach to international development cooperation which will facilitate a progressive transition in which the LDCs build up productive capacities and international competitiveness, and rely increasingly on domestic resource mobilization and private capital inflows for their development finance needs.

The Report complements and builds on the Least Developed Countries Reports (*LDCR*s) of the last two years, which were concerned, respectively, with the place of LDCs in the multilateral trading system and the problem of market access (*LDCR 1998*), and with the need to develop productive capacities in the LDCs and national policies which could facilitate that process (*LDCR 1999*). This Report briefly reviews economic growth and social trends in the 1990s. But it focuses in particular on the question of financing development in the least developed countries. This is essential not simply for addressing the pressing social needs of these countries. It is vital for accelerated economic growth and the development of productive capacities, for successful structural adjustment and integration into the world economy, and for reduced vulnerability to external shocks and natural disasters.

In order to facilitate discussions at UNLDC III, the Report discusses the scale of the development finance challenge in LDCs, the scope for meeting this challenge through domestic resource mobilization, and the constraints which are limiting the LDCs' access to international capital markets and attractiveness for FDI. From the analysis, two key features of the development financing patterns of LDCs emerge. First, the central accumulation and budgetary processes of the LDCs are dominated by external rather than domestically generated resources. Second, almost all the external finance for most LDCs comes from official sources. The development prospects of most LDCs thus still depend critically on aid relationships and associated external debt dynamics. The Report examines how these have been working in the 1990s and whether the current rethinking of international development cooperation is likely to rectify the deficiencies of the past.

The main analytical conclusion of the Report is that *the current diagnosis for change which is shaping the new approach to international cooperation is flawed in several crucial respects.*

This conclusion merits careful consideration. If the diagnosis is right, and changes are made accordingly to national and international policies, the new approach to international cooperation will increase the probability that more and more LDCs will move into the take-off scenario in which domestic resource mobilization increases, FDI is attracted and access to international finance markets is opened up. But if the diagnosis is wrong, with whatever ingenuity the implied policy changes are made, and with whatever energy and good faith they are implemented, there is no reason why we should expect better results this time round. The most likely outcome at the end of the coming decade will be a new round of aid fatigue for the new approach and a new round of debt relief to pay off the latest wave of ineffective official loans.

It is imperative for UNLDC III to end up with policy proposals and commitments that are based on a correct diagnosis of the weaknesses of past domestic and international policies. The Report is oriented to that end, and it makes constructive proposals for improving international cooperation for LDCs in the field of development finance in a way which can, in the end, facilitate a progressive transition away from aid dependence.

THE ANATOMY OF THE DEVELOPMENT FINANCE PROBLEM IN THE LDCs

One of the main weaknesses of discussions of development finance is that too little attention is paid to the heterogeneous nature of developing countries. The Report thus seeks at the outset to set out the main features of the development finance problem of the LDCs by comparing their patterns of domestic resource mobilization and reliance on external finance with other developing countries as well.

The evidence over the long term shows that when per capita income increases in LDCs, there is a strong domestic savings effort. Indeed, the development effort in LDCs, as measured by the degree to which extra income is saved, is at least as strong as in other developing countries. If growth can be sustained, therefore, significant increases in domestic resource mobilization may be expected which would, in due time, reduce dependence on external finance and usher in the possibility of a more self-sustained growth process.

However, because of the very low income per capita of most LDCs and their sluggish or even negative per capita growth rates, this potential for domestic resource mobilization is not being realized. With many people living from hand to mouth, and with a very weakly developed corporate sector, domestic savings are necessarily very low. This not only limits domestically financed economic growth but is also a fundamental source of the vulnerability of LDC economies. The size of the external shocks in the LDC economies, in terms of income losses inflicted, are often many times the size of the resources that these countries can muster internally to cope with such shocks. Indeed, in relation to the domestic resources available for finance, the average LDC economy has, since the 1970s, been exposed to adverse external trade shocks with an impact, in the worst years, more or less double the average of other developing countries.

Despite the extremely low levels of domestic resources available for financing purposes, the LDCs have managed to some extent to raise their investment levels. In doing so they have relied heavily on external finance. However, investment and public expenditure in the African and Asian LDCs as a share of GDP is still well below the average of non-LDC developing countries, indicating inadequate access to external sources of finance. In the light of the special needs of the LDCs – given their very low levels of socioeconomic infrastructure, high degree of vulnerability to external shocks, high rates of environmental depletion, as well as high rates of human capital resource depletion arising from the prevalence of diseases such as AIDS – this implies a serious underinvestment in these economies. The low level of investment is likely in itself to have harmed the efficiency of any investment made.

The LDCs are thus caught in a trap, with low incomes and slow growth limiting the scope for domestic resource mobilization, and low rates of investment and low efficiency of resource use in turn limiting growth. The only way to escape is through external finance.

Possible sources of external finance include, on the one hand, official capital flows, in the form of grants or loans, provided by bilateral and multilateral aid agencies, packaged with or without technical assistance, and, on the other hand, private capital flows, from sources which include banks, capital markets, companies and individuals, taking the form of short- and long-term loans, acceptance of company and government bonds, portfolio and direct investment. But in spite of the globalization of production and finance which has been occurring in the 1990s, only a few LDCs have been able to attract significant private capital inflows.

The reasons why foreign investors and lenders are deterred from placing their money in many LDCs are related to costs of asset development, risks which are rooted in the vulnerability of LDCs to shocks, lack of business support services, weak physical, social and administrative infrastructure, and the small scale of most projects. International capital markets are also characterized by imperfections which limit LDCs' access to private finance even when projects are economically viable. Economic growth seems to be a key factor which affects whether developing countries can attract private capital inflows. Thus, just as with domestic resource mobilization, one may envisage a virtuous circle getting under way if growth can be sustained in the LDCs, and in this way, FDI and private credit could in the long run substitute for official grants and official debt-creating flows. But for the moment, ODA is the major source of external finance, and the LDCs and their development partners are dependent on using aid to break out of the vicious circle of low incomes, low savings and inadequate investment in which many LDCs are caught.

The record of the 1990s

Economic growth and social trends

The real GDP of the LDCs as a group grew by 3.2 per cent per annum during 1990–1998, as against 3.4 per cent for the low- and middle-income countries as a whole and 2.5 per cent for the world. This was a minor improvement over the economic performance in the 1980s. Moreover, the gap between the LDC growth rate and the growth rate of other developing countries also narrowed in the 1990s. However, a significant part of the aggregate LDC growth is attributable to a single country, Bangladesh, which accounts for a quarter of the economic size of the LDC group, and which grew at higher and more stable rates than most other countries in the group. The growth rate for the LDCs without Bangladesh was 2.4 per cent during the period 1990–1998. Also, the population growth rate for LDCs was significantly higher than the developing country average, and almost double that of the world average. Taking this into account, real GDP per capita in the LDCs grew at only 0.9 per cent per annum during 1990-98, and excluding Bangladesh, by only 0.4 per cent per annum.

This does not compare favourably with the real GDP per capita growth rates in other developing countries which were 1.9 per cent per annum during the 1980s, and 3.6 per cent per annum during 1990–1998. During the 1980s, the simple average of the per capita growth rates in the other developing countries was double that of the LDCs, and in the period 1990–1998 it was four times higher than that of the LDCs. This indicates a growing average per capita income gap between the LDCs and other developing countries. Compared with low-income countries, the overall growth performance of the LDCs as a group also appears slow. Per capita GDP in low-income countries, largely because of high rates of growth in China and India, increased at annual rates of 4.3 per cent and 5.4 per cent during the 1980s and the 1990s respectively. This indicates that the LDCs are being rapidly overtaken by other low-income countries.

There are, however, important divergences among LDCs. There is a group of 15 LDCs where real GDP per capita growth exceeded 2 per cent per annum during 1990-1998. Of these, seven are in Asia. At the other end of the spectrum there are 22 LDCs which have been stagnant or in economic regress during the same period. In eleven of these, all of which have experienced serious armed conflicts and internal instability during the 1990s, the real GDP per capita has been declining by over 3 per cent per annum over this period. Overall, 32 LDCs have either relatively fallen behind the other developing countries in terms of per capita income, or have experienced absolute deterioration in living standards, during 1990-98.

Within the overall economic performance in the 1990s, there are significant differences between the early and the later part of the decade. For the LDCs as a whole the growth of real per capita GDP was low and declining each year in the early 1990s, but it jumped significantly and became positive in 1995. Since then, it has been relatively high but declining each year. The turning point corresponds to the most sustained improvement in the terms-of-trade of the LDCs since the early 1980s. Between 1988 and 1993, the terms-of-trade of the LDCs on average fell by about 12 per cent, but in 1994–1995 there was an upturn that was sustained until 1997.

The terms-of-trade of the LDCs worsened in 1998 and 1999 with a drop in commodity prices whose breadth and depth has not been seen since the early 1980s. The composite index of non-oil commodity prices fell by more than 30 per cent during the period 1998–1999. However, the price index of crude oil, which dropped by over 30 per cent in 1998, has increased sharply since early 1999, and has witnessed a more than threefold increase between March 1999 and August 2000.

The implications of commodity price changes for the terms-of-trade of different LDCs has been varied, of course, depending on the nature of their trade specialization and the composition of their imports and exports. During 1998, the oil-exporting LDCs were hard hit, while the impact of the pervasive primary commodity price declines on oil importers was to some extent alleviated because of cheaper oil prices. Since March 1999, however, the precipitous increase in oil prices has benefited the oil exporters, while the non-oil primary exporters have been doubly hit by low primary commodity prices and rising fuel import bills. Some of the small island LDCs which have specialized in services exports (e.g. Maldives), or Asian LDCs which have specialized in manufacturing exports (e.g. Bangladesh), are expected to be less adversely affected by the primary commodity price declines than by the increase in oil prices. In general, the decline in the terms-of-trade since 1998 has been particularly severe for the primary commodity exporting and oil importing countries, i.e. the majority of the LDCs.

The social trends in the LDCs in the 1990s are mixed. But three features give cause for concern. First, economic growth was too slow in most LDCs to make a significant dent in the unacceptably high rates of poverty. Second, whilst significant social achievements were being made in a few countries, the rates of social progress have generally lagged behind those required to meet the international goals established at the global summits of the 1990s, and the gap between the LDCs and other developing countries is often widening. Third, almost a quarter of the LDCs are caught in a downward spiral in which economic regress, social stress and violent conflict mutually reinforce each other.

The Paris commitments

In 1990, as an outcome of the Second United Nations Conference on the Least Developed Countries (UNLDC II), which was held at Paris in September 1990, the international community committed itself to urgent and effective action to arrest and reverse the deterioration in the socioeconomic situation in the least developed countries and to revitalize their growth and development. The commitments, set out in the Paris Declaration and the Programme of Action for the Least Developed Countries for the 1990s, are wide-ranging, but at their heart there was an implicit partnership. The LDCs undertook to deepen the process of economic reform which they had begun in the 1980s, whilst their development partners undertook to make available a significant and substantial increase in the aggregate level of external support to the LDCs.

The record of the 1990s shows that there has been an accelerating process of economic liberalization in many LDCs. In fact 33 out of the 48 LDCs have undertaken policy reforms under the IMF-financed Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF) programmes since 1988. The main exceptions to this movement are LDCs which are ineligible as their per capita incomes are too high, or States that have experienced severe civil conflict or sanctions by the international community. Amongst those LDCs which have initiated reforms, the process has, of course, been deeper and longer in some than in others, and it has also been carried out with numerous intermittent interruptions. But one third of the LDCs involved have been in these programmes for over half the time between the beginning of 1988 and the end of 1999, and 27 countries have been engaged in implementing the agreed policies for three years or more during that period. Reforms have also been stronger in some domains than in others. But the available evidence suggests that the LDCs have kept up with other developing countries in the process of structural reform in all areas except financial sector reform and the reform of the public enterprise sector, and they have gone further than other developing countries in the area of pricing and marketing reform. When slippage on policy commitments did occur, it was more often than not due to missing fiscal targets than reneging on structural reforms. Indeed, the only systematic hard evidence on causes of programme interruptions shows that, for the LDCs, slippage on policy commitments related to structural reform was a cause of programme interruptions in less than 15 per cent of the interruption episodes.

As a consequence of these reforms, the policy environment in many LDCs changed significantly in the 1990s. IMF data actually show that trade liberalization has proceeded further in the LDCs than in other developing countries. In 1999, for 43 LDCs for which data are available, 37 per cent had average import tariff rates of below 20 per cent coupled with no or minor non-tariff barriers, whilst amongst the 78 other developing countries in the sample, only 23 per cent had this degree of openness. Indeed, 60 per cent of the 43 LDCs had average tariff barriers which were below 20 per cent and non-tariff barriers which were moderate in the sense that they were not pervasive, covering less than 25 per cent of production and trade. Similarly, UNCTAD data for the late 1990s show that, in a sample of 45 LDCs, only 9 maintain strict controls on remittances of dividends and profits and capital repatriation. Twenty-seven LDCs have adopted a free regime, guaranteeing such transfers, whilst nine have a relatively free regime, either by controlling capital repatriation (while allowing free remittances of dividends and profits) or requiring the Government's prior authorization of such transfers.

Whilst the process of economic reform in the LDCs has been widespread and in many cases deep, the implementation of the external finance commitments made in Paris in 1990 has been weak. In order to reach, as soon as possible, a flow of concessional resources commensurate with the increase called for, donors agreed to seek to implement the following targets:

- Donor countries already providing more than 0.20 per cent of their GNP as ODA to LDCs: continue to do so and increase their efforts;
- Other donor countries which have met the 0.15 per cent target (set by the Substantial New Programme of Action for the Least Developed Countries for the 1980s): undertake to reach 0.20 per cent by the year 2000;
- All other donor countries which have committed themselves to the 0.15 per cent target: reaffirm their commitment and undertake either to achieve the target within the next five years or to make their best efforts to accelerate their endeavours to reach the target;
- During the period of the Programme of Action, the other donor countries: exercise their best efforts individually to increase their ODA to LDCs so that collectively their assistance to LDCs will significantly increase.

In practice, the share of aid to LDCs in DAC donors' GNP fell from 0.09 per cent in 1990 to 0.05 per cent in 1998, and in that year only five DAC members met the targets of the Programme of Action, namely Denmark, Luxembourg, the Netherlands, Norway and Sweden.

As a consequence, aid flows to the LDCs have been declining, particularly since 1995. Net ODA from DAC countries is estimated to have been $12.1 billion in 1998, down from $12.6 billion in 1997. For the LDCs, the decline in 1998 was the third year of uninterrupted decrease, representing a cut of more than $4.5 billion since 1995. The decline in 1998 contrasts with the more positive developments