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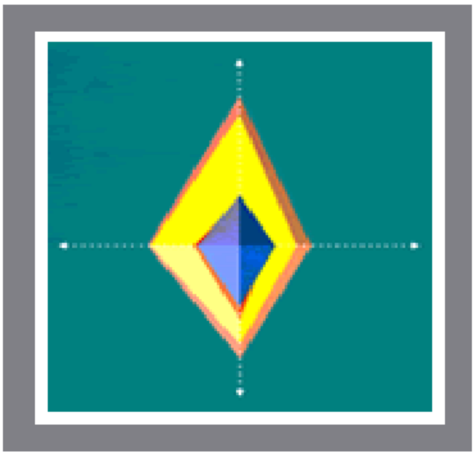
THE LEAST DEVELOPED COUNTRIES 1996 REPORT

OVERVIEW
by the Secretary-General of UNCTAD



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The Least Developed Countries 1996 Report (UNCTAD/LDC(1996)/Overview

OVERVIEW: LDCs IN A GLOBALIZING WORLD ECONOMY

INTRODUCTION

The growing interest in both official and private quarters in the phenomenon of globalization and its companion, the process of economic liberalization, has generated much thinking and analysis about its origin, its impact on economies and societies, and on the pattern of its likely evolution. Although much publicity has surrounded some of the analysis, it is clear that these multifaceted phenomena have important implications which governments, businesses and analysts all over the world must address. Much of the analysis and thinking has focused on the more visible aspects of globalization, notably, the sea-changes taking place in the pattern of production, pace of diffusion of knowledge and information and in the convergence of factor markets. Less well understood and analysed, however, is the phenomenon of marginalization.

It is far from clear how those economies and societies, including most of the LDCs that are at the periphery of global processes - and have been so over very long periods - will be affected by the recent trends. Questions such as whether globalization will assist their integration in the world economy or whether the new challenges will further weaken their already precarious links are far from academic but are at the centre of the development policy debate. There is a danger that the fragile economic and social position which characterizes many of the LDCs will deteriorate further unless major efforts are made by the LDCs, supported by the international community, to adjust to the challenges of globalization and liberalization.

The paragraphs that follow address some of these issues and attempt to outline the key role of designing appropriate policies to meet the challenges. While the discussion stresses the LDCs' perspectives, it nevertheless has relevance for other poorer economies and indeed for wider global community.

Globalization and Liberalization

The world economy is increasingly being shaped by the processes of globalization and liberalization. These are interrelated and multifaceted processes encompassing the growth of international trade in goods and services and capital flows, the global integration of production processes, the dominance of market-oriented economic policies throughout the world, and a significant degree of institutional harmonization between countries in respect of trade, investment and other policies mediated through multilateral and regional institutions. Globalization and liberalization are processes that are unlikely to be reversed in the foreseeable future and have profound implications for LDCs in terms of their position in the world economy, their development prospects and the nature of their economic policies.

Integration of Developing Countries into the World Economy

Many countries in the developing world have made substantial progress in economic development over the course of the last two to three decades. Progress has been most marked in East Asia, but has not been confined to this region. The successful developing countries (DCs) have achieved rapid rates of economic growth, established internationally competitive industries, gained a growing share of world export markets, attained high rates of investment in physical and human capital, and have begun to close the disparities in income between themselves and the industrialized countries. Integration into the global economy has facilitated the development efforts of these countries, particularly through the opportunities it has provided them to accelerate the growth of their exports and to access foreign capital and technology. Globalization, however, may have converse effects for some of the weaker DCs, and, in particular, could lead to their marginalization.

Marginalization of the LDCs

While many DCs have assumed an increasingly prominent role in the global economy, many of the LDCs are becoming marginalized from the mainstream of the world economy. Marginalization is the consequence of the combination of developments in the global economy that have not been favourable to weaker economies, such as the LDCs, or to their internal political and economic problems. These two sets of factors have interacted to reinforce their marginalization.

As a group, the LDCs have not fared well in terms of economic development over the last two decades, although some individual countries have made significant progress. Economic growth has been very slow and has failed to keep pace with rapid population growth, as a consequence of which per capita incomes and living standards have declined and poverty has intensified.

The marginalization of a significant number of the LDCs from the mainstream of the world economy is reflected in an array of important economic and social indicators. Not only have LDC growth rates lagged behind those in other DCs since the early 1970s, but the LDCs’ share of world exports and imports has fallen sharply. The LDCs have attracted a negligible share of global flows of foreign investment, and their investment rates, as a percentage of GDP, have been much lower than the average for all DCs. They have achieved very little structural change and remain heavily dependent upon primary commodities for export earnings and on official development assistance (ODA) to finance a large share of their investment and government budgets.

Growing Income Inequalities

A related manifestation of the marginalization of the LDCs is the increasing income disparities between them and both the industrialized countries and other DCs. The differential in per capita incomes between the countries with the poorest 20 per cent of the world population (a group that consists mainly of the LDCs) and the richest 20 per cent widened considerably between 1960 and 1991, as did the disparity between the poorest countries and those in the middle range of the income distribution (see the box below). Conversely, income disparities between the industrialized countries and the middle range of the income distribution have narrowed, reflecting the economic advances made by many of the DCs.

Reasons Underlying the Poor Economic Performance of the LDCs

The poor economic performance of the LDCs, both in absolute terms and relative to that of other DCs, reflects the impact of a number of factors. About one third of the countries in the LDC group have been afflicted by acute civil strife and political instability which have severely retarded development efforts and, in some cases, have had devastating economic and social consequences. Restoring peace and security is imperative if development is to begin again in these countries. In other LDCs, a range of problems relating to structural constraints, adverse external shocks, such as depressed commodity prices and the debt crisis, and policy weaknesses have impeded development efforts. Most of these countries have implemented policy-reform programmes in recent years designed to liberalize their economies and to enhance their integration into the international economy. Policy reforms have made some impact in terms of economic stabilization, but in most LDCs have yet to stimulate the significant acceleration of growth rates that is required to revive their economies.

This report argues that the processes of globalization and liberalization offer LDCs important long-term opportunities to reverse the economic decline that they have experienced over the last two decades, but that these processes also raise serious concerns for these countries. In the absence of appropriate policy responses from the LDCs and the international community, globalization and liberalization may do little to alleviate the trend towards their marginalization from the world economy and may even accentuate it.

Opportunities for LDCs in the Global Economy

The opportunities provided by globalization and liberalization arise mainly from changes in the global economy which are likely to enhance market opportunities for LDCs' exports, and may stimulate increased foreign investment. Growth in world trade is expected to be robust over the next decade as a result of the Uruguay Round trade liberalization and the growth of new markets in the transitional and developing economies, which should stimulate demand for LDCs' exports. It is also likely that new markets will emerge for LDCs to develop niche exports in areas such as horticulture and tourism, and that as wages rise in the newly industrialized economies (NIEs), labour-intensive manufacturing exporters may relocate to LDCs to take advantage of lower labour costs, which would provide a stimulus for export diversification in the LDCs. Integration into world markets offers major advantages for LDCs, not least because their own domestic markets are too small to provide viable investment opportunities for many potential investors. However, LDCs may not be able to exploit the opportunities offered by globalization because of pervasive supply-side constraints.

Supply-side Constraints

The ability of LDCs to take advantage of the emerging opportunities in world markets depends crucially on their ability to foster the development of internationally competitive industries which can meet exacting standards of cost, quality, reliability and delivery schedules. Supply capacities in LDCs are, however, very weak for a variety of reasons and this is likely to be the major constraint on their ability to exploit the opportunities arising from globalization. In particular, the private-enterprise sector, which is the key agent of development, is not well developed in most LDCs and its growth is constrained by shortages of capital and of entrepreneurial, managerial, technical and marketing skills. Technological capacities in many industries in LDCs are rudimentary, which, together with the low levels of educational attainment of the workforce, is a major impediment to raising productivity. Some of the services necessary to support production, such as the provision of adequate finance or marketing services, are often lacking or are very expensive. There are serious deficiencies in the physical infrastructure with the land-locked countries, in particular, facing very high transport costs to access international markets. Supply-side constraints have always been an impediment to development in the LDCs, but their importance has been heightened by globalization and liberalization because of the increasing premium on the efficient production of traded goods.

Risks for LDCs from Intensified Competition

Globalization and liberalization present a number of potential dangers for LDCs which, unless they can overcome the supply-side constraints discussed above and improve the productivity of their industries, threaten to accentuate their marginalization in the world economy, which is becoming more competitive as protected markets are increasingly opened up by liberalization and as competition among exporters is boosted by new entrants emerging from previously closed transitional and developing economies. Consequently, LDCs will face intensified competition in their major export markets in the industrialized countries and in their own domestic markets. This competition is potentially problematic for LDCs because many of their industries, especially those that were established to serve protected markets, are likely to be less efficient than their competitors and may lack the resources required to improve efficiency to the levels necessary to compete. LDCs may therefore suffer a further erosion of their share of world export markets and a possible loss of domestic market share to increased import competition.

Costs and Benefits of the Uruguay Round for LDCs

The imperatives of global integration have provided the stimulus for the conclusion of the Uruguay Round of reforms to the multilateral trading system. This is likely to provide a significant stimulus to world trade and therefore potentially enhance trading opportunities for LDCs. Although reaching definitive conclusions as to the costs and benefits of the Uruguay Round Agreements for particular countries is difficult at this stage, the major gains are likely to accrue to the industrialized countries and NIEs that have already established internationally competitive industries and which are thus in a position to compete in liberalized markets, rather than to the LDCs.

The Uruguay Round may also impose costs on LDC economies through a number of channels. As a result of Uruguay Round MFN tariff cuts, the LDCs will suffer an erosion of tariff preferences in their export markets: these are provided under GSP schemes and (for those LDCs which are members of the ACP group) the Lomé Convention. However, preferences *per se* have not been very effective in boosting LDC exports in the past and their reduction therefore may have limited practical impact. Agricultural liberalization in the industrialized countries is likely to induce a rise in world food prices. As many LDCs are net food importers, this will have an adverse effect on their terms of trade as well as on domestic food security. There may also be costs for the LDCs arising from compliance with notification requirements, policing various agreements and in participating in WTO activities. Some of the LDCs' potential concerns were acknowledged in the Final Act of the Uruguay Round which provided them with special and differential treatment allowing them greater flexibility and a longer time-frame to comply with multilateral commitments.

Constraints on Access to Foreign Capital

More than any other group of DCs, the LDCs are heavily dependent upon external finance to fund trade deficits, supplement government budgets and finance investment. The major sources of external finance for the LDCs are concessional funding from official sources and foreign direct investment (FDI). But their marginalization risks undermining their access to both sources of external finance.

Because their domestic private sectors are so weak, LDCs require the capital, technology and skills that FDI can provide if they are to improve supply capacities in their industries. Foreign investment in the developing countries has risen markedly in the last few years, but very little of it has been directed towards the LDCs. Their share of the total FDI flows to all DCs amounted to only 1.1 per cent in 1992-1994. FDI has been concentrated in the richer and more dynamic DCs, especially those in East Asia and Latin America. Furthermore, some foreign companies have been disinvesting from some LDCs in Africa in order to refocus their operations on other regions of the world where economic prospects are regarded as more promising.

As part of wider programmes of economic reform, many LDCs have reformed their investment policies in an attempt to attract FDI. But foreign investment in these countries is deterred by a variety of factors not readily amenable to policy reforms: the small size of the domestic market, inadequate infrastructure, falling world prices for primary commodities, and, in some cases, political instability.

With limited access to private capital, the role of ODA in meeting LDCs' external financing needs has assumed even greater importance. ODA flows to LDCs have, however, stagnated in the last few years. Some of the donors have re-prioritized their aid commitments, for political or commercial reasons, away from the LDCs. With the end of the cold war, most of the LDCs no longer have much strategic significance for the major donors and are perceived as providing few commercial opportunities for firms from the donor countries, while political instability has severely reduced the absorptive capacity for external finance in some LDCs. Hence, LDCs are facing severe constraints on their access to concessional finance at a time when enhanced flows of external resources are most needed.

Trends in World Commodity Markets

Most LDCs remain dependent upon exports of primary commodities to generate their foreign-exchange earnings. Trends in world commodity markets since the 1970s, however, have not been favourable to LDCs. There has been a long-run decline in the real prices of many of the commodities which are of particular importance to LDCs, such as coffee, copper, cotton and tea. This reflects the fact that the growth in world market demand for primary commodities has lagged behind that of other products, partly because of a fall in the commodity intensity of final expenditures, while supply has been boosted by productivity increases linked to the application of new technology in some important supplier countries. It is possible, but by no means certain, that the demand for some primary commodities, especially metals, minerals and agricultural raw materials, may pick up over the medium term because of the rapid economic growth in Asian countries where the demand for raw materials is outstripping supply.

The LDCs have also lost market share in the world markets for many of their major primary commodity exports, including coffee, copper, metals and minerals because of domestic production constraints and productivity improvements in competitor countries. Reversing this trend in their market share is imperative if the LDCs are to participate more fully in the global economy.

Regional Trading Arrangements

Despite the multilateral agreements reached under the Uruguay Round, the growth of regional trading arrangements (RTAs) has accelerated, with new RTAs being established, the membership of existing RTAs expanded, and formal links established between different RTAs. Most LDCs are themselves members, together with other DCs, of RTAs in their own regions. But they are not included in the major RTAs, such as the EU and NAFTA, which encompass their major export markets. This has potentially important implications for the LDCs.

The creation of an RTA entails the granting of preferential market access to its own members, and hence discrimination against non-members. LDCs therefore stand to suffer a relative erosion of the terms of market access in their major export markets as a result of the growth of RTAs covering these markets, with the danger that their exports will lose market shares to exports originating from within the RTA. From the perspective of the LDCs wishing to expand and diversify their exports, it is imperative that RTAs maintain a liberal trading stance towards the rest of the world (i.e. do not raise protectionist barriers to non-members). LDCs will be in an especially vulnerable position if competing trade blocs turn inward looking, with each adopting protectionist policies towards non-members.

The African LDCs, in particular, are involved in a number of RTAs in their own regions (ECOWAS, COMESA and SADC are among the largest of these groupings), but these RTAs have not yet proved effective in stimulating intraregional trade flows. There is limited complementarity in the economic structures of the different country members, intraregional transport links are often poor, while the degree to which trade barriers between members have actually been removed has been limited, partly because governments have lacked the political will to vigorously pursue regional trade integration which might threaten the interests of domestic producers. Nevertheless, such RTAs would offer potential advantages to LDCs if intraregional trade were effectively liberalized, especially because their own domestic markets are so small. Domestic firms would enjoy the benefits of the larger regional markets, allowing them to exploit economies of scale, while the increased competition would stimulate improvements in efficiency. Regional markets may provide a useful training ground for domestic firms seeking to raise productivity to international standards before entering global export markets. The larger regional market might also prove more attractive to investors than individual country markets.

Implications of Globalization and Liberalization for Economic Policy in LDCs

Responding to the challenges posed by globalization and liberalization will require major adjustments in economic policies, resource allocation and production structures in the LDCs. The primary burden of adjustment will inevitably have to be borne by the LDCs themselves, although international support is essential. The nature and quality of domestic policies will play a crucial role in determining whether LDCs can successfully adjust to the changing demands of the global economy.

Globalization and liberalization have important implications for the nature of economic policies in LDCs. The scope for autonomous national economic policies has undoubtedly been narrowed as a result of these trends in the world economy. Direct controls by governments over economic activities within their own national boundaries (e.g. controls on capital movements) have become less effective and often counter-productive, as private-sector economic agents are more easily able to evade the impact of such controls. As a consequence, governments have few options other than to pursue market-oriented economic policies.

The focus of economic policies has therefore shifted towards the creation of an enabling environment for the private sector and the efficient operation of the market economy. This entails maintaining macroeconomic stability, developing an appropriate legal and regulatory framework (to enforce contracts and protect property rights), and ensuring the efficient provision of public goods, such as education and health services, which cannot be supplied in an optimal manner by the market.

At the same time, globalization has significantly enhanced the premium on good macroeconomic policies and exacerbated the adverse repercussions of bad policies.

Because of the increasingly competitive nature of global trade and factor markets, the latitude that governments may once have had to follow inappropriate policies, such as overvalued exchange rates, without inflicting serious damage on their economies, has been diminished.

Maintaining macroeconomic stability, adopting outward-oriented trade policies and avoiding excessive distortions in markets will be crucial policy requirements for all LDCs. In addition, public policy must address the critical supply-side constraints that impede the ability of their economies to compete effectively on global markets. Although the requirements of individual LDCs will not be identical, several areas are likely to warrant the attention of policy makers. These include strengthening the export sectors, improving agricultural technology in order to enhance farm productivity and output and rehabilitating and expanding the physical infrastructure. Major efforts are also required to enhance human-resource development, particularly by raising the level of educational attainments, which is crucial to raising the productivity and competitiveness of the economy.

The adjustment efforts of LDCs require more support from the international community. A crucial role for the international community will be to provide adequate levels of concessional finance to fund the infrastructural and social development programmes of LDC governments and to provide the balance of payments and budgetary support to facilitate economic-reform programmes. Technical assistance to enhance capacities for policy formulation and implementation in LDCs is also required. The international community must ensure that the market access of LDC exports is not undermined by protectionism, and that the growth of RTAs covering the major industrial countries does not damage the trading interests of LDCs.

LDCs' Recent Growth Performance

After many years in which the per capita incomes of some LDCs stagnated and others declined, LDC economies displayed some modest progress in 1994 and 1995. GDP growth was estimated to have averaged over 3 per cent in these two years. Of the 48 LDCs, 14 were estimated to have experienced strong economic expansion in 1995, with output growth of more than 5 per cent. Barring adverse weather conditions, LDC output growth in 1996 should be sustained and reach the same level as in 1995, notwithstanding the expected weakening of certain commodity prices.

The overall improvement in LDC economic performance was due to a combination of factors including the progress made in enhancing political and social stability in some countries, the benefits accruing from the impact of domestic economic-policy reforms, favourable weather conditions, and increased commodity prices from about 1994 which are likely to be reversed within the next year or two. The efforts to implement more prudent fiscal and monetary management, so as to reduce macroeconomic imbalances, contributed to lower inflation in several countries and the return of investor confidence. Increased export-tax revenues due to higher export earnings, together with the curtailment in the growth of public expenditures, have contributed to an improvement in public finances in a number of LDCs.

African LDCs

The most notable improvement in economic performance has occurred in the African LDCs, although their growth rates remained modest in comparison with Asian LDCs. Aggregate GDP growth of the African LDCs was estimated to have increased to 2.2 per cent in 1995, compared with an annual average growth rate of 0.6 per cent in 1990-1994. Eight of these countries experienced output growth of more than 5 per cent in 1995: their economies benefited from the favourable international and domestic environment, with buoyant commodity prices boosting export earnings.

The 1994 CFA franc devaluation also helped to stimulate economic activities and encouraged increased inflows of foreign capital to some CFA member states. While favourable weather boosted agricultural output in many LDCs, drought conditions afflicted some of the poorest countries of Southern Africa. There was significant progress in implementing macroeconomic reforms in many LDCs. Some countries, however, continued to experience difficulties in reducing their excessive budget deficits: this resulted in high interest rates and deterred the private investments necessary for sustained GDP growth. Although signs of peace and relative stability started to emerge in some African LDCs in 1995, civil strife continued to afflict others and impeded the revival of their economies.

Assuming normal climatic conditions, the overall GDP growth of African LDCs should be maintained in 1996 at about the same rate as in 1995. Moreover, there is potential for some countries to accelerate their output growth rates through the expansion of their agricultural and mineral sectors.

Asian LDCs

Economic growth of Asian LDCs increased to 4.6 per cent in 1995, from 4.0 per cent in 1994. Two thirds of the Asian LDCs succeeded in expanding output by more than 5 per cent, with three of these countries achieving growth rates close to 7 per cent. The impetus for growth was provided by the revival of business confidence induced by a deepening of reform measures, which included the maintenance of realistic exchange rates and low inflation rates, together with enhanced cooperation in trade and investment with neighbouring countries, particularly in South-East Asia. The economies of many of the Asian LDCs have also benefited from the social stability that prevails in these countries. Favourable weather conditions contributed to a good agricultural performance in a majority of the countries in the region, while industrial growth remained robust and several countries recorded an encouraging export performance. Some of the Asian LDCs have begun to attract FDI, often in the form of joint ventures with local investors, in various sectors from agriculture to infrastructural improvements. However, these countries still face enormous problems, with large sections of the population unemployed and living below the poverty line.

EXTERNAL FINANCE

Overall Aid Flows are no longer Increasing

For several decades, the increase in aggregate DAC ODA to developing countries as a whole broadly corresponded with increases in donor countries' GNP, but the period of steady growth in ODA appears to be over. Shortages of ODA are likely to continue into the future with LDCs competing with other developing countries and new aid claimants for scarce aid resources. International commitments made in the Programme of Action in 1990, and subsequently endorsed at recent major global conferences, appear to have had little impact on donor policies (see chart).

The key features of diminution in the importance of external resource flows to the LDCs in the first half of this decade include:

- stagnation of ODA;
- reductions in the GNP share of donor countries allocated to foreign-aid programmes;
- limited contribution of private capital to net-resource flows to LDCs;
- decline in support from some multilateral institutions over the last two years;
- the continuing drain on resources deriving from debt-servicing obligations.

In nominal terms, ODA flows have stayed relatively stable over the first half of the 1990s, although in real terms they have contracted since 1991. The share of LDCs' ODA in DAC donors' GNP declined from 0.09 per cent in 1990 to 0.07 per cent in 1994 - less than half of the aid targets and commitments set at the Paris Conference, and with fewer donor countries meeting those targets than in 1990.

Some donor countries have made laudable efforts to maintain, and even increase, their aid budgets to LDCs. Five countries - Denmark, the Netherlands, Norway, Portugal and Sweden in 1994 continued to meet and exceed the 0.20 per cent target. However, due to modest growth and widespread unemployment, a number of donor countries have cut back their aid budgets and reduced allocations to LDCs. In the United States, reducing the budget deficit and cutting expenditure have become overriding policy concerns: likewise, some members countries of the European Union striving to meet the Maastricht criteria for participation in the single currency of the European Monetary Union by 1999 have also adopted further fiscal restraints. In these circumstances, aid budgets have become an easy target, with no clearly defined constituency to defend them. Japan, currently the second largest donor to the LDCs in dollar terms, has also been undergoing a prolonged period of economic weakness and is also likely to result in a slow-down in its aid programme.

LDCs Struggle to Meet Policy Conditions

Policy conditions have come to the centre of donor-recipient relations, notably for access to Structural Adjustment Loans and Structural Adjustment Facilities of the World Bank and IMF, respectively. Of late, political conditionality relating to "good governance", including the guarantee of human rights has also assumed increased importance.

Many LDCs have weak administrative and institutional capacities that hamper the local design and "ownership" of reform and development programmes, as well as their implementation. In most cases, these limit LDCs' real absorptive capacity and impede the effectiveness of aid.

Besides economic-policy reform, a significant number of LDCs have, since the early 1990s, undertaken wide-ranging political reforms and have instituted mechanisms for democratization and increased popular participation in the development process. Carrying out these two major reforms in tandem has overstretched the weak administrative capacities of most LDCs and held up progress on economic reform measures, thereby slowing down aid inflows. In other LDCs, political conflicts and civil strife have led to the suspension of regular development programmes and projects.

Decline in Aid to LDCs is not Inevitable if Priorities are Set Right

The fiscal constraints in donor countries need not necessarily lead to a reduction of ODA flows to the neediest countries, such as the LDCs, if aid programmes are refocused and prioritized. With even modest increases in the funding of multilateral aid programmes and priority allocations to LDCs within bilateral aid, it should still be possible to meet the aid targets and commitments set out in the Programme of Action and ensure adequate ODA financing for the LDCs. The mid-term review of the implementation of the Programme of Action in late 1995 suggested specific measures to incorporate these targets and commitments into the donors' national aid strategies and budgetary planning mechanisms. In parallel, possible new sources of ODA financing need to be explored: the mid-term review meeting invited developing countries, which have developed the capacity to assist over the last few years, to join the traditional donor countries in providing assistance to LDCs. Contributions by non-governmental organizations should also be encouraged.

To counteract the possible marginalization of LDCs in ODA financing, the donor community, together with its LDC partners, will have to address procedural as well as performance-related absorptive capacity constraints. The former may stem from complex aid procedures and practices, which are different for each bilateral donor and agency, procurement restrictions, regulations within the recipient countries themselves, and insufficient coordination of aid programmes, among others. The second set of policy-related constraints, connected with the current stringent aid conditionality which many LDCs find difficult to fulfil, calls for increased efforts at capacity-building and realism in setting performance criteria: e.g. adapting these to the management and implementation capacities of the recipient countries, seeking to smooth the path of adjustment rather than block support when countries run into difficulties.

LDCs' External Financing Situation Remains Precarious

Although issues like the effectiveness and targeting of aid are important, the question of the volume of aid remains a crucial concern. The current flow of aid is in part based on past commitments, as disbursements are made for programmes and projects agreed earlier. However, commitments have fallen back in recent years. The precarious position of LDCs' external financing is indicated by the fact that, during the first half of the decade, net transfer of resources has been possible in part due to factors such as default on a part of LDCs' debt service obligations, through debt relief and through the accumulation of arrears.

The Outcome of ongoing Multilateral Replenishment Exercises will be Crucial

In order to maintain and expand aid flows to the LDCs, absorptive capacity constraints have to be addressed, as suggested above. But funding capacity and a sufficient pipeline of commitments also have to be secured. In this respect, 1996 will be a critical year. Much will depend on developments in the major donor countries, and the outcome of ongoing negotiations on the replenishment of the concessional windows of the international financial institutions, which are key sources of financing for the LDCs.

In the United States, the leading donor country so far for the LDCs in terms of aid volume, public and political support for the aid budget remains doubtful. Major cutbacks in the United States aid budget would have serious consequences for LDCs, and possibly have repercussions on support from other donor countries as well. At the end of 1995, the capacity of the International Development Association (IDA) to undertake its planned 1996 operations was in doubt, largely because of the uncertainty about the United States Congress authorizing the funds to meet the current commitments to IDA. Similar pressures influenced the negotiations on the next IDA replenishment, due to take effect at the beginning of July 1996, and discussions on the provision of new resources to the African Development Fund and the Asian Development Fund, both of which are in line for replenishment.

Bolder Action on LDCs’ External Debt is Needed

ODA financing has to be complemented by concerted efforts on the debt strategy for the poorest countries, with a view to reducing their external obligations to sustainable levels. A number of mechanisms have been set up to deal with the specific debt problems of low-income countries, including schemes for ODA debt relief and other official debts to Paris Club creditors and for buying back liabilities to commercial banks. Given its size, and the increasing burden of servicing it, the multilateral component of LDC debt has assumed critical importance. Then again, their preferred creditor status appears to lessen the options to deal with it. Discussions on policies to deal with this component of the debt of poorer countries have been going on for some time now in the Bretton Woods institutions, but progress has been limited. The ad hoc solutions adopted so far have had little impact on the LDCs’ debt overhang. A significant number of LDCs, in particular those that experienced stagnant growth and/or decline in their export earnings in the early 1990s, are still unable to meet their debt-servicing obligations.

Bolder action is needed on this front, in addition to the provision of new ODA financing. This should include, in many cases, a substantial reduction of the outstanding debt stock. A comprehensive and concerted approach is needed: a sufficiently endowed facility to deal with multilateral debt, together with extended implementation of existing schemes, could play a key role in achieving overall debt sustainability. Nevertheless, other mechanisms may still be needed to deal with other specific LDC debt problems, such as liabilities stemming from debt contracted with the former socialist states and the debt burden of conflict-stricken countries in some of which systems of governance have broken down. Moreover, for some of the LDCs with heavy debt burdens, eligibility criteria under existing schemes is blocking debt relief. The debt problems of LDCs are still very far from a durable solution.

FINANCIAL-SECTOR REFORMS IN LDCS

Major economic-policy reforms have been implemented in most of the LDCs to facilitate their adjustment to the challenges posed by liberalization and globalization. An important component of the policy-reform programmes in many LDCs has been financial-sector reforms. The financial sectors of LDCs display a variety of weaknesses which are a serious impediment to the growth of a dynamic market economy. These weaknesses include low levels of financial depth, a lack of diversification in financial markets, the exclusion of important sections of the economy from access to credit and other financial services, banking markets characterized by inefficiency and oligopoly, and widespread financial fragility among banks and other financial institutions. These problems are attributable partly to the effects of previous financial-sector policies which sought to control financial markets in order to meet non-commercial objectives: financial fragility, for example, has been most acute among government-owned banks whose lending has been heavily influenced by political criteria.

Financial-sector reforms in the LDCs have encompassed a number of objectives: enhancing the efficiency of financial intermediation, boosting deposit mobilization, stimulating greater competition in financial markets and addressing the problems of financial fragility. The overall aim of the reforms is to promote the development of a competitive, efficient and prudently-managed financial sector capable of providing the financial services required to support the growth of a dynamic private enterprise sector. The main components of the reforms have been financial liberalization, the restructuring of distressed financial institutions, and the strengthening of systems of prudential regulation and supervision. Most of the reforms have been initiated relatively recently and in many countries are still in the process of implementation.

Financial Liberalization

Financial liberalization in LDCs has mainly comprised the reduction or removal of allocative controls over interest rates and lending, the introduction of market-based techniques of monetary control and the easing of entry restrictions on private capital.

There are some indications that financial liberalization has stimulated greater competition, at least in some segments of financial markets, with the entry of new banks and other financial institutions. One of the benefits of this is that banks are beginning to improve and expand the range of services they offer to the public, particularly through investment in new technology. In addition, liberalization has encouraged the government financial institutions to place more emphasis on the application of commercial principles in determining lending decisions and in their overall operations.

The impact of financial liberalization on the efficiency of resource allocation has, however, been limited, largely because of problems relating to macroeconomic instability and financial fragility. Large government budget deficits in several LDCs have forced nominal interest rates to very high levels and crowded the private sector out of credit markets. Some of the government banks, which dominate financial markets in some LDCs, require major financial and managerial restructuring to enable them to perform as efficient commercially oriented financial intermediaries. Furthermore, there are serious imperfections in some sections of the credit markets in LDCs which impede access to credit by potentially important borrowers, such as small farmers, from commercially oriented financial institutions. These imperfections centre around informational problems, lack of suitable loan security, deficiencies in legal systems that impede loan recovery and high transactions costs. Effective institutional solutions to these problems have not yet been devised in most LDCs.

Bank Restructuring

Bank-restructuring programmes are currently under way in several LDCs to tackle the problems of insolvent (mainly government-owned) banks. The restructuring of these banks entails re-capitalization, usually with funds provided by the government budget, the replacement of their non-performing assets with other assets (usually government bonds), radical changes to their management and operating procedures and the rationalization of staffing levels and branch networks to reduce operating costs. The difficulties involved in these restructuring exercises are substantial: not only are the financial costs (which will ultimately be borne by taxpayers) enormous, but there are likely to be political constraints to the type of major rationalization needed to restore viability to these banks.

Reforms to Prudential Regulation and Supervision

Reforms to the prudential systems in LDCs have entailed revisions to the banking laws and the strengthening of bank supervision departments. Prudential regulation had not been accorded much priority until the late 1980s, with the banking laws having become outdated in most LDCs and bank supervision departments severely understaffed. As a result of the reforms, the legal framework for prudential regulation has been significantly improved in many LDCs, with banking laws brought into line with international standards. While some progress towards strengthening supervisory capacities has been attained, personnel shortages in supervision departments remain a constraint to effective supervision.

Further Progress Required

The LDCs have made a start in implementing financial reforms in order to foster the development of more efficient and prudently managed financial sectors. Progress has been made in removing distortionary allocative controls and in enacting new financial legislation to strengthen prudential regulation, while many LDCs have also begun to restructure government-owned banks. Reforming the financial sectors in LDCs is, however, an ongoing task and a great deal remains to be done.