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Enhancing the enabling environment at all levels

to strengthen productive capacity, trade and investment:

mobilizing resources and harnessing knowledge for development

Developing productive capacities in least developed countries

Note by the UNCTAD secretariat

I. The current policy context

1. In recent years, gross domestic product (GDP) growth in the least developed countries (LDCs) as a group has significantly improved. However, a number of LDCs, particularly in Africa, continue to experience very sluggish growth or economic regression. Moreover, even in the more successful countries, growth associated with the current pattern of insertion into the global economy, based on commodity exports, low-skill manufactures and tourism, remains highly vulnerable to recurrent shocks and crises. There is a lack of economy-wide improvement in terms of productivity, value added by domestic producers and long-term structural change. Most significantly, the current Poverty Reduction Strategy Papers (PRSPs) have led to a form of economic growth which is not sufficiently stimulating productive investment or creating sufficient jobs.

2. Many LDCs are now at a critical moment of economic transition in which they face a double challenge. Firstly, more and more people are seeking work outside agriculture and urbanization is accelerating. For the LDCs as a group, the decade 2000–2010 is going to be the first in which the growth of the economically active population outside agriculture is predicted to be greater than the growth of the economically active population within agriculture. This transition will affect more than half the LDCs during the decade and even more in the decade 2010–2020. Secondly, the LDCs must manage this transition in an open-economy context. Very few LDCs have restrictive trade regimes at present and most have undertaken rapid and extensive trade liberalization. But their existing production and trade structures offer very limited opportunities in a rapidly globalizing world driven by new knowledge-intensive products and services with demanding conditions of market

entry. At the same time, rapid opening up in more traditional sectors is exposing existing producers to an unprecedented degree of global competition. Benefiting from recent technological advances requires advancing towards and crossing various thresholds in human capital, research and development, and management practice, which most LDC economies have lacked the resources to do. The relentless logic of cumulative causation strongly threatens to push LDCs even further behind.

3. The current commodity booms can represent a window of opportunity for many LDCs. But this requires that windfall rents are productively used to create a more sustainable productive base and growth trajectory.

II. Productive capacities as the basis for a paradigm shift

4. There is a widespread search for pragmatic and constructive alternatives to the “one-size-fits-all” economic model. UNCTAD has argued in the *Least Developed Countries Reports* of 2006 and 2007 that the key to achieving sustained development and poverty reduction in the LDCs is to put the development of productive capacities – and the related expansion of productive employment – at the heart of national and international policies. This will entail a nuanced policy reorientation towards facilitating the process of diversification through capital accumulation and accelerating technical change, with a view to generating changes in the structure of the economy toward sectors with higher domestic value added.

5. In line with the principle of policy diversity, given the variety of the LDCs, heterogeneity of market conditions between countries at different levels of economic development, as well as structural global asymmetries, the shift to a productive-capacities-led policy approach will have to be flexible and take into account differences in development and income levels, economic structures and factor endowments. But focusing on building productive capacities will require a paradigm shift with respect to current national and international policies – a different approach to poverty reduction, to productive capacities and to international trade.

III. The nature of the paradigm shift

A. The approach to poverty reduction

6. The paradigm shift advocated here places production and employment at the heart of efforts to reduce poverty. This does not mean that social sector spending and human development targets are unimportant. Indeed, health, education and social welfare should be seen as part of the process of developing productive capacities. However, it goes beyond this. It links sustained and substantial poverty reduction to the development of a productive base of a society. A society’s capacity to consume is related to its capacity to produce. Employment expansion is at the heart of poverty reduction.

B. The approach to productive capacities

7. The idea of developing productive capacities is not absent from the current policy approach. However, the paradigm shift advocated here involves a different approach to the development of productive capacities.

8. At present, the emphasis is on improving the overall investment climate, in particular through the reduction of bureaucratic red tape and governance-related costs of doing business. But whilst this is important, it is insufficient in an LDC context characterized by extensive structural weaknesses. In this context, there is a need for a more proactive approach to developing productive capacities which encompasses:

- (a) Macroeconomic policies oriented to promote growth, investment and employment;
- (b) A multi-level approach which not only seeks to set the framework institutions and macroeconomic environment, but also includes policies to change meso-level production structures and institutions, and seeks to strengthen the positive synergies between macroeconomic and microeconomic processes; and
- (c) An active approach to promoting entrepreneurship.

9. Within this approach, much more attention is given to building entrepreneurial capabilities and production linkages, as well as promoting structural transformation. This is a precondition for benefiting from current globalization processes and also for ensuring a form of economic growth which substantially reduces poverty.

C. The approach to international trade

10. The paradigm shift advocated here also involves a different approach to international trade. Since the early 1980s, there has been a strong tendency for ideas from international trade theory to dominate understanding of development processes. This occurred initially through comparisons between the relative success of “outward-oriented” and “inward-oriented” development strategies, which were associated with particular trade policy regimes. But it was reinforced in the 1990s through arguments that fast and full integration with the world economy was the key to seizing the opportunities of globalization and minimizing the chance of being left behind. From this perspective, global integration began to substitute for national development as the major policy objective of Governments.

11. Recent experience shows that this is much too simplistic, and indeed the most successful developing countries have not followed the orthodox policy prescription. In the approach advocated here, international trade is seen as essential for the development of productive capacities, and the development of productive capacities is seen as essential for international trade. But the paradigm shift entails starting at the development end – rather than the trade end – of the relationship between trade and development. National and international policies which can facilitate this must be rooted in a development-driven approach to trade rather than a trade-driven approach to development. The policy approach advocated here thus focuses first on production, and then from this perspective, identifies how international trade can support capital accumulation, technological change, structural change, employment creation and poverty reduction. What matters is not to maximize trade, but to maximize these beneficial effects of trade.

IV. Key issues for discussion

12. The round table will examine the need for the paradigm shift which is being advocated here and what the focus on developing productive capacities means for the design of national policies to promote development and poverty reduction in LDCs, and international support measures for LDCs by their development partners.

13. **Issue one:** Is placing productive capacities at the heart of national and international policies to promote development and poverty reduction the right approach? How radical a departure from current policies does it entail?

14. LDCs first began undertaking economic reforms in the early 1980s. This process picked up significantly in the late 1980s and early 1990s, and has subsequently been deepened through the implementation of second-generation reforms, particularly through the medium of PRSPs. There is a wide sense of dissatisfaction with the results of these policies for people’s lives. As the 25th anniversary of this process passed in

2007, is it now time to think of a change and to move beyond processes of stabilization, adjustment and reform? What are the implications of the productive capacities approach for the PRSP approach, which encompasses both national policies and an international aid strategy, as well as the design of national poverty reduction strategies?

15. **Issue two:** Given the extent of structural weaknesses in LDCs, what should be the priorities for developing productive capacities and what policies can most effectively achieve those priorities?

16. The *LDC Report* of 2006 argues that national and international policies to develop productive capacities should focus on relaxing key constraints on capital accumulation, technological progress and structural change. The key constraints to developing productive capacities are identified as (a) low levels of physical infrastructure and human resources; (b) poorly functioning or non-existent institutions (especially financial and knowledge systems); and (c) a weak domestic enterprise sector (the missing middle) accompanied by a lack of effective demand. Are these the right strategic priorities?

17. Policies to develop productive capacities are multi-dimensional and complex. However, the *LDC Report* has identified finance and knowledge as the two critical ingredients of the process of developing productive capacities. Policies need to address both these ingredients.

18. **Issue three:** Can knowledge, technological learning and innovation provide a key entry point for the design of policies to promote development of productive capacities in LDCs?

19. Knowledge is becoming increasingly important in global production, and there is a danger that the LDCs will be even further marginalized if they do not develop the knowledge content of their economies and diversify through learning and innovation. As argued in the *2007 LDC Report*, the current market-based patterns of technology flows to LDCs (trade, foreign direct investment and licensing) are not contributing to narrowing the global knowledge divide. Sustained economic growth and substantial poverty reduction cannot occur in the present context of liberalization without learning and of global integration without innovation. A debate is envisaged over, among other things, what national policymakers and their development partners can do to rectify this situation, with a view to exploring possible solutions to the following policy challenges:

- (a) How can science, technology and innovation (STI) policies geared toward technological catching up be integrated into the development and policy reduction strategies of the LDCs?
- (b) How do stringent intellectual property rights regimes affect technological development processes in LDCs and what are the policy options for improving the latter's learning environment?
- (c) How can the loss of skilled human resources through emigration be addressed?
- (d) How can aid for STI (as part of official development assistance (ODA)) be used by LDCs and their development partners to support technological learning and innovation in the LDCs?

20. **Issue four:** What is the best way to promote domestic resource mobilization and reduce aid dependence?

21. While ODA to LDCs has been increasing in nominal terms since 2000 (to approximately \$25 billion by 2004), this is largely attributed to the rise in emergency assistance and debt forgiveness grants. The long-term shift in the composition of aid

away from production sectors and towards social sectors has been reinforced in recent years. Due to low levels of domestic resource mobilization, LDCs remain in conditions of unhealthy aid dependency. LDCs should reduce this aid dependence through policies that accelerate economic growth, by devising alternative development financing strategies aimed at increased domestic resource mobilization, growth in export earning and other non-aid resources. For this to occur, they need policy space to develop their own development finance mechanisms. International donors should support such indigenous financing mechanisms.

22. Key questions are:

- (a) How can LDCs use the Paris Declaration as a tool for reducing aid dependence?
- (b) How can they galvanize their domestic resources to finance development of productive capacities?
- (c) How should LDC Governments achieve better aid management?
- (d) How can ODA flows be reoriented toward productive capacities and economic infrastructure?

23. **Issue five:** Is it possible to design a new and more effective generation of international support measure for LDCs based on priority to the development of productive capacities?

24. A major aim of the round table will be to contribute to building political consensus and an analytical basis for a new generation of international support measures for LDCs. Such measures should dovetail with national policies and work more effectively to achieve sustained growth, productive employment generation and poverty reduction. At the Third United Nations Conference on the Least Developed Countries (UNLDC III) in Brussels, the major innovative idea was the Everything But Arms initiative of the European Union. The overall aim should now be to move away from an exclusive reliance on preference-based paradigms and to work towards an analogous high-profile initiative which is centred on the development of productive capacities in the LDCs. This may include:

- (a) Recognition of the need to enhance the scope of knowledge aid and reorient aid towards STI and developing productive capacities in LDCs;
- (b) International initiatives aimed at setting up donor-supported national innovation funds aimed at using STI as a key tool of development and poverty reduction in LDCs;
- (c) More effective use of aid to finance domestic enterprise development in the LDCs;
- (d) Setting up research-oriented networks and alliances between research and development institutes in LDCs and other countries in the area of STI;
- (e) Carrying out studies in areas such as a review of international best practices in building productive capacities, implications for LDCs, and the role of the State in the new policy framework; and
- (f) Training programmes in building productive capacities, for example, STI capacity-building programmes for policymakers in LDCs.

V. Further Reading

25. The analysis of this note is based on:

- (a) *The Least Developed Countries Report 2006: Developing Productive Capacities*; and
- (b) *The Least Developed Countries Report 2007: Knowledge, Technological Learning and Innovation for Development*.

26. These reports provide more detailed empirical information on trends in the development of productive capacities in LDCs, outcomes of current national and international policies, and proposals for new national and international policies oriented towards the development of productive capacities.
