

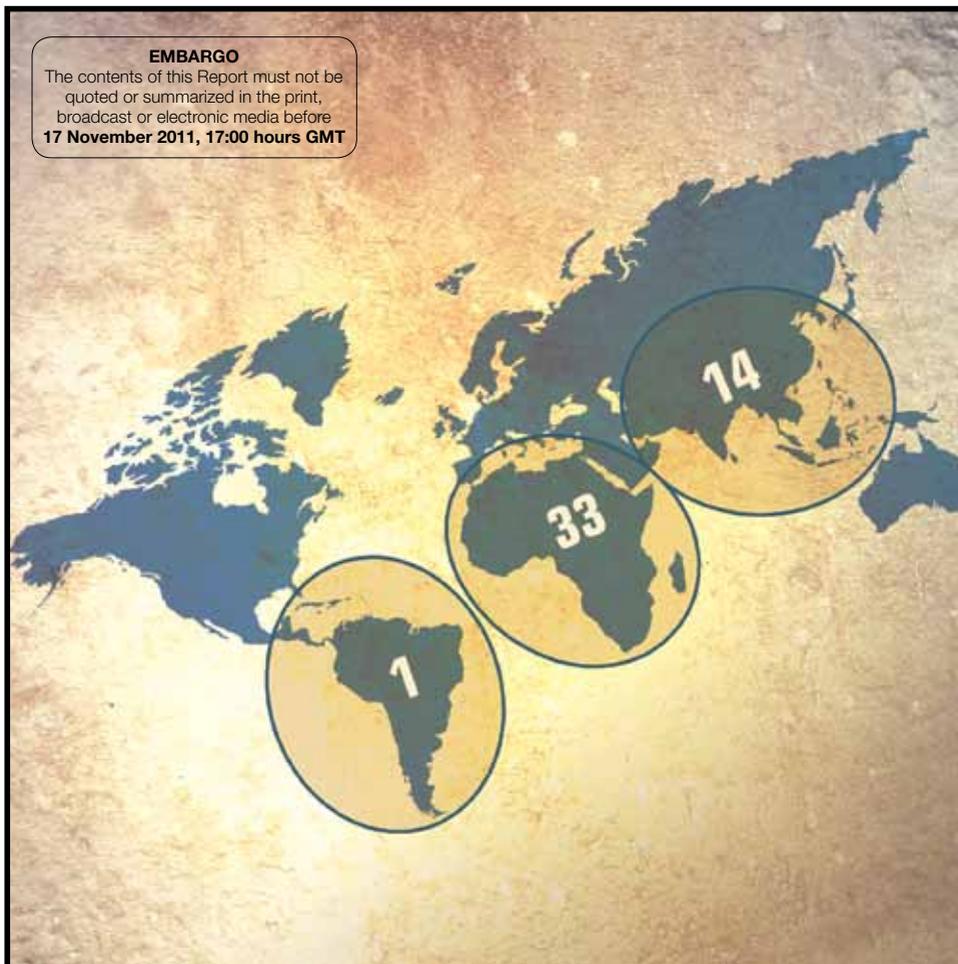
THE LEAST DEVELOPED COUNTRIES REPORT 2011

The Potential Role of South-South Cooperation for Inclusive and Sustainable Development

OVERVIEW

EMBARGO

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UNCTAD/LDC/2011 (Overview)

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Introduction

This year has been a significant one for the least developed countries (LDCs). From 9 to 13 May, Heads of State and Government and Representatives of States gathered in Istanbul for the Fourth United Nations Conference on the Least Developed Countries (LDC-IV) to discuss the specific development challenges facing the LDCs and to deliberate on actions which could best enable their accelerated, inclusive and sustainable development. At the end of the Conference, member States declared their collective commitment to a renewed and strengthened global partnership for the development of the LDCs, and they adopted a new Programme of Action for the Least Developed Countries for the Decade 2011–2020.

The overarching goal of the Istanbul Programme of Action (IPoA) is “to overcome the structural challenges faced by least developed countries in order to eradicate poverty, achieve internationally agreed development goals and enable graduation from the least developed country category” (para. 27). This goal is expected to be achieved through national policy actions and international support, which focus on (a) achieving sustained, equitable and inclusive economic growth in LDCs of at least 7 per cent per annum; (b) building human capacities; (c) reducing the vulnerability of LDCs to economic shocks and disasters, as well as climate change, and strengthening their resilience; (d) ensuring enhanced financial resources and their effective use; and (e) ensuring good governance at all levels. The aim is to enable half the LDCs to reach the criteria for graduation by 2020 (para. 28).

An important feature of the IPoA is the enhanced importance given to building the productive base of LDCs’ economies and promoting structural change. In this regard, one third of the priority actions agreed by LDCs and their traditional development partners focus on (a) productive capacity-building; (b) agriculture, food security and rural development; (c) trade; and (d) commodities.

Only two LDCs graduated from LDC status during the last decade. It will therefore need a major up-scaling of effort at both national and international levels to ensure that at least half the LDCs reach the graduation criterion over the next 10 years. For part of the last decade, the gross domestic product (GDP) of the LDCs as a group grew by over 7 per cent. However, this growth did not generate sufficient productive employment opportunities, despite a

rapidly growing labour force. Poverty reduction has therefore been slow. A shift in the development model is required to promote sustained and inclusive economic growth.

The key to achieving the ambitious goals of the IPoA is implementation. LDCs themselves have committed to integrate the policies and measures in the IPoA into their national and sectoral development strategies. Development partners have committed to integrate it into their respective national cooperation policy frameworks, programmes and activities. And developing countries have also committed to support effective implementation consistent with their capacities and through South–South cooperation. As paragraph 12 puts it:

“Guided by the spirit of solidarity with least developed countries, developing countries, consistent with their capabilities, will provide support for the effective implementation of the programme of action in mutually agreed areas of cooperation within the framework of South–South cooperation, which is a complement to, but not a substitute for, North–South cooperation”.

The *Least Developed Countries Report 2011* focuses in particular on the potential role of South–South cooperation in supporting inclusive and sustainable development in LDCs. It puts forward a policy framework for enhancing the development impact of South–South cooperation. And it proposes how to leverage South–South financial cooperation for development in the LDCs.

Recent economic trends and long-term outlook and development perspective

In 2010, LDCs grew by 5.7 per cent, one percentage point higher than in 2009, but far below the average of 7.1 per cent attained during the boom period. Asian LDCs fared better than African and island LDCs, both during the crisis and afterwards, because of the “pull” effect of their regional trading partners, and their more diversified export structure. Although the LDCs taken as a group did not experience a contraction of economic activity during the global recession, one fifth of them did fall into a recession. The growth rate on a per capita basis was negative in 18 LDCs in 2009 and in 9 in 2010. Finally, six LDCs saw their economic growth in per capita terms contract in two consecutive years (2009 and 2010).

The outlook for the medium term is that the high growth rates of the pre-crisis economic boom are unlikely to be achieved. The International Monetary Fund (IMF) forecasts for the LDCs indicate that the growth rates from 2009 to 2016 would be on average around 5.8 per cent, i.e. almost one and a half percentage points slower than during the boom period. Thus, in the next five years, LDCs as a group would not be able to reach the growth rate of 7 per cent, which is one of the main goals of the IPoA for the decade 2011–2020. Forecasts by country indicate that only 10 LDCs of the total of 48 would reach the target rate.

International trade has a decisive influence on the economic performance of LDC economies. While the value of export of merchandise from the LDCs grew five-fold from 2000 to 2008, the volume exported increased by only 97 per cent. This illustrates the strong effect of commodity prices on the export boom during the 2000s. Exports declined sharply in value terms in 2009 (-28 per cent), driven by the slump in the exports of African LDCs (-33.6 per cent). They have since recovered, partly owing to higher commodity prices. But the exports of goods in 2010 were still below the 2008 level.

The substantial increase in fuel and food prices in the last two years has again adversely affected many LDCs. Combined with a drought in Eastern Africa, it has led not only to food insecurity but also to a widespread famine affecting around 9 million people in 2011. Given the high commodity dependence of the LDCs, both as net exporters and net importers, the volatility of their prices has clear detrimental consequences for these economies.

One of the salient features of the high growth rate during the 2000s in the LDCs was the increase in external financial flows. While the sum of foreign direct investment (FDI) inflows and workers' remittances barely reached \$10 billion at the beginning of the decade, they were more than five times greater in 2008. However, the global recession reversed some of these previous trends, so the FDI in 2010 (\$26.4 billion) was \$6 billion smaller than in 2008 (\$32.4 billion). In contrast, workers' remittances continued to grow even during the crisis, albeit more slowly. Likewise, the net ODA disbursement, together with the net debt relief, increased from almost \$13 billion in 2000 to \$38.6 billion in 2008. The aid to LDCs has continued to increase, even during the crisis, and reached a record level of \$40.1 billion in 2009, the equivalent of 8.3 per cent of their GDP.

The current external conditions are such that lower growth rates and lower export dynamism of the LDCs may be expected in the present decade,

coupled with more volatility, especially in commodity prices, and most worryingly, high fuel and food prices. The trends also portend somewhat weaker private external capital inflows and possibly less aid. The recovery from the recent food, energy and economic crisis is, at best, partial in the LDCs, and the current world economic situation and the outlook in the mid-term are not promising either.

THE DEVELOPMENT CHALLENGE IN LONG-TERM PERSPECTIVE

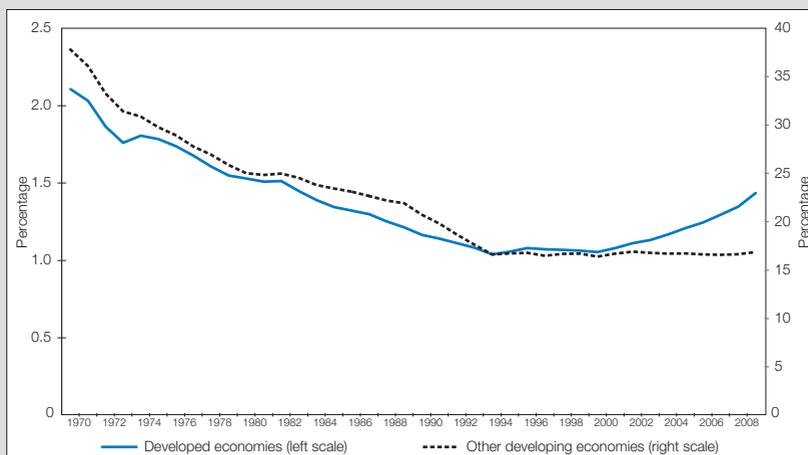
The scale of the development challenge facing LDCs is not simply a matter of the new post-crisis global economic environment — it also must be understood against the background of long-term economic and social trends.

In this regard, the continuing marginalization of LDCs in the global economy is apparent in a number of dimensions. While LDCs represent a significant and increasing share of world population (12 per cent in 2009), their contribution to global output remains below 0.9 per cent, considerably lower than what it was in the mid-1970s. In other words, one eighth of the world's population produces less than one 100th of the world total GDP. With regard to international trade, the LDCs' share of world merchandise exports hovered around 0.6 per cent between the 1980s and the early 2000s, and has climbed to 1 per cent more recently. The bulk of the recent improvements, however, is accounted for by fuels; excluding that product line, LDCs accounted for only 0.53 per cent of world exports in 2009.

The position of LDCs looks marginally better with regard to FDI flows. In 2009, their economies received around 2.5 per cent of total FDI inflows worldwide. This does indeed represent a small improvement compared to the last couple of decades, but should be evaluated against a global context of surging FDI flows to developing countries, and growing demand for primary commodities.

Finally, relative to other country groups (developed economies and developing economies excluding the LDCs), the real GDP per capita in LDCs decreased from the beginning of the 1970s until the mid-1990s (chart 1). During that period, the LDCs real GDP per capita, relative to that of developed countries, declined from above 2 per cent to only 1 per cent. Relative to the real GDP per capita of other developing countries, the LDCs had fallen from almost 40 per cent of their level in 1970 to less than 20 per cent by the

Chart 1. Real GDP per capita in LDCs relative to other country groups, 1970–2009



Source: UNCTAD secretariat calculations, based on *UNCTADstat* database.

mid-1990s. The increased dynamism of LDC economies during the 2000s has reversed these trends. But the real GDP per capita of LDCs was only 1.5 per cent of that of developed economies in 2009. Moreover, despite the economic boom in LDCs in the 2000s, there has been no improvement of the real GDP per capita of LDCs relative to other developing countries. Thus, even with the growth performance they recorded during the 2000s, LDCs were not able to start a process of closing the gap with other developing economies. To embark on a sustained catching-up path, the LDCs will have to substantially improve their economic performance.

Turning to social trends, UNCTAD's assessment of poverty reduction trends and millennium development goals (MDG) achievements (*Least Developed Countries Report 2010*: chapter 1) indicates that some progress is being made in the LDCs, with an acceleration of achievement since 2000. Poverty reduction is, however, particularly weak and most LDCs are off track to meet most human development MDGs. Overall progress is very slow.

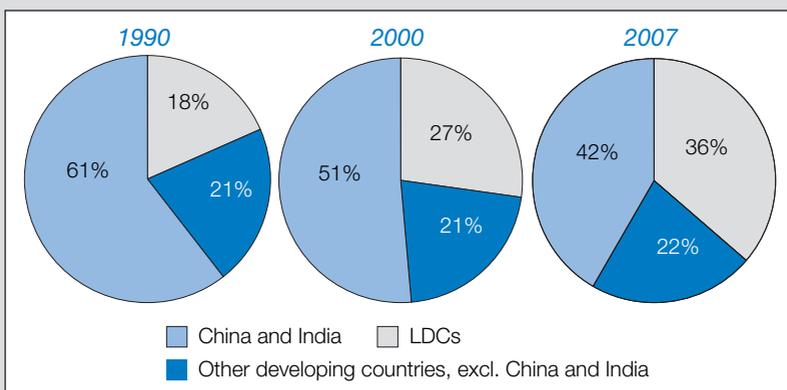
The main feature of poverty in LDCs remains its all-pervasive and persistent nature: in 2007, 53 per cent of the population was living on less than \$1.25 a day, and 78 per cent on less than \$2 a day. This implies that 421 million people were living in extreme poverty in LDCs that year. The incidence of

extreme poverty was significantly higher in African LDCs, at 59 per cent, than in Asian LDCs, at 41 per cent. For the \$2-a-day poverty line, however, the difference was less marked: 80 per cent in African LDCs and 72 per cent in Asian LDCs.

It is estimated that the number of extreme poor living in LDCs by 2015 will be 439 million, while if the MDG target were achieved it would be only 255 million.

Another way of looking at these trends is to compare the share of total number of people living in extreme poverty in developing countries who are in LDCs (chart 2). In 1990, China and India accounted for 61 per cent of the people living in extreme poverty in all developing countries. By 2007, this figure has gone down to 42 per cent, largely owing to China, where the number of poor people more than halved in 20 years. In contrast, the share of the global extreme poor who were living in LDCs has increased from 18 per cent in 1990 to 27 per cent in 2000, and reached 36 per cent in 2007. Given current trends, and the continuation of business as usual, it is clear that, over time, LDCs will become the major locus of extreme poverty in the world.

Chart 2. Distribution of people living in extreme poverty across developing countries, 1990, 2000 and 2007
(Below 1.25 \$/day)



Source: UNCTAD, 2011f.

A major effort will be needed to make a difference now and achieve the goals of the IPoA. This will require action in a variety of areas. This *Report* focuses on the potential for South–South cooperation.

The rise of the South: Development implications for LDCs

One of the key features of the last decade or so has been the rising importance of some developing economies in the global economy and the intensification of South–South economic relationships. From the point of view of the LDCs, the multi-faceted process of reconfiguration of the world economy has translated, most notably, into a remarkable strengthening of their economic ties with Southern countries. As a consequence, although traditional Northern partners remain crucial, South–South relations now play an important and increasing role in LDCs’ integration into the world economy. Further, they are likely to acquire an even greater prominence in the future, given the significant downside risks that loom on the recovery in developed economies, as well as the need for a global rebalancing.

A critical development issue for LDCs is whether the dynamism of their intensifying relationships with Southern economies can serve as a springboard for developing their productive capacities, facilitating structural transformation, and providing more productive jobs and livelihoods, which are the necessary basis for substantial poverty reduction.

THE TYPE AND IMPORTANCE OF LDC-SOUTH ECONOMIC RELATIONS

The intensification of economic ties between the LDCs and other developing countries is a complex and multifaceted process, encompassing not only trade and investment, but also migration and official financial flows.

UNCTAD’s analysis of international trade shows that, throughout the 2000s, the rapid expansion in LDCs’ exports and imports has been driven by a mounting prominence of Southern markets and sources of supply. By 2009, LDCs’ merchandise exports to Southern partners were worth \$68.5 billion. This compares with \$59.5 billion to developed and transition economies. In other words, developing countries in 2009 absorbed more than half of LDCs’ merchandise exports, up from 40 per cent at the beginning of the

decade. The above shift in LDCs' export destinations has been paralleled by the simultaneous evolution of their merchandise imports. In a decade during which the LDCs' imports bill rose from \$42 billion in 2000 to almost \$144 billion in 2009 (after the peak in 2008), developing countries expanded their market share by roughly 10 percentage points. As a result, nowadays they account for well over half of LDCs' total merchandise imports.

An important feature of LDCs' trade with Southern partners, however, is its geographic concentration. A few large developing countries (mostly in the Asian region) account for the overwhelming share of LDCs' exports to and imports from the South. Such a concentration is coupled with huge asymmetries between individual LDCs and their main Southern partners, in terms of economic size, as well as the dependency on each other's market. The two Asian giants, China and India, play a particularly prominent role in LDCs' growing integration with other developing countries. China and India became respectively the first and fourth largest markets for LDCs' exports, and the second and third source of LDCs' imports in 2009. Beyond them, though, a much broader array of countries is involved in the multifaceted process of South–South economic integration, ranging — just to name a few — from Brazil to South Africa, from Thailand to Saudi Arabia, and from Malaysia to Turkey.

A major feature of the composition of exports from LDCs to developing countries is the important role of commodity exports. Indeed, the growth of commodity exports has largely driven the expansion of LDCs' exports to the South while the growth of manufactures exports, often within the context of preferential market access schemes, has played a more prominent role in the expansion of LDCs' exports to the North. In 2009, only 15 per cent of LDCs' total manufactures exports went to Southern markets, while the latter received over half of LDC total exports of fuel and minerals. Besides, as much as 68 per cent of LDC agricultural raw materials exports (including products like cotton) were sent to Southern destinations. Manufactures imports, particularly from China, India, South Africa and Thailand, dominate the composition of imports of LDCs from developing countries.

Though less discussed in the literature, migration-related issues also deserve great attention in the context of the growing South–South economic relations. While data reliability is far from perfect, it is estimated that only one of four migrants coming from the LDCs moved to a developed country. One of five went to another LDC, and approximately half of all migrants went

to other developing countries. Accordingly, it is estimated that in 2010 two thirds of the nearly \$26 billion of remittances received by the LDCs originated in Southern countries, despite the fact that migrants working in developed nations tend to remit larger sums. In particular, Southern economies such as India, Saudi Arabia, Gulf Cooperation Council countries and South Africa play an important role for diasporas originating in many LDCs, including the largest recipients of remittances, namely Bangladesh, Nepal and Sudan.

Finally, there are increasing financial flows between LDCs and other developing countries, including both FDI and official financial flows. Between 2003 and 2010, when total FDI inflows to the LDCs were growing on average at nearly 20 per cent per year, the share of FDI projects accounted for by Southern investors climbed from 25 per cent to upwards of 40 per cent. While these investments are still largely related to extractive industries, there are signs of incipient diversification to other economic sectors, such as finance, telecommunication, tourism and manufacturing, with promising implications in terms of innovation and technological transfers. Southern official flows to LDCs have also surged rapidly over the last few years. Though South–South official financial flows are rather small in relationship to traditional ODA disbursements to LDCs, their focus on infrastructure and productive sectors render them very conducive to developing productive capacities.

DEVELOPMENT IMPLICATIONS FOR LDCs

The *Report* suggests that the development implications of these intensifying and multi-dimensional economic relationships between LDCs and other developing countries can be analysed through three major approaches: (a) the flying geese paradigm, (b) a traditional centre-periphery model, and (c) a growth pole approach.

The first approach — the flying geese paradigm — presents a broadly positive picture of evolving economic relationships between more advanced and less advanced developing economies which occurs as the former industrialize. It explains the successes of Newly Industrializing Economies by relating the life cycle of particular sectors over their course of development, with the relocation of industries from more advanced to less advanced countries in the region in response to shifts in competitiveness. Once they manage to emulate the “leader” and establish themselves as exporters of a new product, the “followers” are gradually encouraged by competitive

pressures to repeat the same pattern of relocation to their less developed neighbours. Simultaneously, more advanced economies not only climb up the ladder of product sophistication, but also function as export markets for the “followers”, by allowing reverse import. If the “follower” countries are in the same region, then the whole process fosters greater regional integration. The mental image of countries as flying geese, all advancing together but at different stages of development, can act in this context as an important indicative programme which establishes expectations.

The second approach is the traditional centre-periphery model. In contrast to the flying geese paradigm, this presents a negative view of the development impact of the rise of the South on LDCs. The centre-periphery model emphasizes the reproduction of old North–South relationships within the South, with the smaller and poorer countries being locked in to commodity dependence, and with asymmetric bargaining power.

The third approach is a growth pole approach. This recognizes that in the context of increasing global interdependence, large and dynamic developing countries have emerged as growth poles in the global economy. Growth poles can exert both positive and negative influences on the economic space to which they are related through a complex field of multifaceted forces.

The evidence presented in this *Report* indicates that the emerging patterns of trade and FDI flows are to some extent reminiscent of the centre-periphery dynamic. However, the actual pattern is more complex, as growing demand for natural resources from Southern countries is increasing the bargaining power of LDCs and boosting domestic resource mobilization thus enabling more policy space. Vibrant South–South trade is also broadening LDCs’ access to low-priced intermediates and consumer goods, with unambiguous benefits for firms using those inputs, as well as final consumers, but some potentially detrimental effects on import-competing industries.

But beyond trade, the emergence of Southern growth poles has provided many LDCs with broader access to financial resources, through workers’ remittances, private and official flows, as well as greater opportunities for technological upgrading. Partly in line with the flying geese paradigm, the incipient insertion of some LDCs into regional and subregional production networks may open up new opportunities of structural transformation, skills acquisition, and technological upgrading. This is particularly evident in Asia, where policy is playing an important role to facilitate the dynamic development of the regional division of labour and growing regional interdependence.

The specificities of each country, the multiple channels through which South–South relations take place, and the set of potential partners are so rich that no single narrative could possibly account for all aspects. But the growth pole approach, which recognizes an array of external effects from the rapid growth and transformation of a few rapidly growing developing countries, some of which are negative and some of which are positive, appears to be the most rounded approach. The key question, from the point of view of LDCs’ development objectives, is to what extent these emerging relationships can be leveraged to promote the development of productive capacities and the diversification of their economies.

The next section of this overview summarizes a policy framework to help LDCs forge a proactive and strategic approach to their integration with Southern partners, while the final section presents a practical application of this framework for leveraging South–South financial cooperation for LDCs’ development.

Activating the developmental State in LDCs: The role of South–South cooperation

The argument developed in this *Report* is that the benefits of South–South cooperation will be greatest when a dynamic (two-way) relationship is established in which policies carried out by “catalytic” developmental States in LDCs and South–South cooperation reinforce each other in a continual process of change and development. In such a dynamic relationship, South–South cooperation supports both the building of the catalytic developmental State in LDCs and the successful achievement of its objectives. The catalytic developmental State in LDCs in turn enhances and shapes the benefits of South–South cooperation. New modalities and structures are required to strengthen the interdependence between the two phenomena in the post-crisis environment. In this regard, developmental regionalism is particularly important.

THE CATALYTIC DEVELOPMENTAL STATE

There is a real and significant opportunity for rapid poverty reduction in LDCs through the development of productive capacities and associated

expansion of productive employment. It can emerge from mobilizing underutilized resources, as well as the addition of new capacity through (a) investment in agricultural productivity, plant and equipment; (b) the diffusion of available technologies; (c) public spending on infrastructure, skills and capabilities; and (d) the creation of new products and markets.

There is no single way to combine these elements into a single “correct” strategy for inclusive growth. However, if history is any guide, a cohesive, strong, catalytic and effective State responsive to the needs of its constituents is one of the prerequisites for defining the content of a long-term development strategy.

The modalities, role and reach of the State in national economic management have tended to fluctuate over time. However, in all dynamic developing economies and in all countries now classified as developed market economies, the government has played an influential role in promoting and supporting economic development. In this context, the coordinating function of the developmental State is stressed, as well as its role in formulating a development vision and creating the policy space required to combine and integrate policy measures in support of structural transformation.

The *Report* defines the developmental State as a set of institutions, tools, capacities and capabilities committed to national development, with a capacity to implement its articulated economic and social strategies. But within this broad definition, it is possible to identify a number of different visions of the developmental State, including the East Asian developmental State and developmental State rooted in Latin American structuralism. Due to the specific vulnerabilities and structural constraints of LDCs and their initial conditions, there is a need to develop a more appropriate model of developmental State, which is especially tailored for LDCs. This *Report*, therefore, proposes the Catalytic Developmental State (CDS).

The CDS focuses on creating new productive capacities rather than “re-allocating” *given* resources and putting *given* productive capacities to more efficient use. In other words, its focus is on creating dynamic comparative advantage, and ensuring financial resources for long-term investment and for evolution of new productive capacities. The CDS approach is more holistic and integrated, encompassing both economic and social development, and needs to ensure that such development is served by finance rather than the other way around.

Each CDS will need to choose the trajectory of development suited for its own economy, ranging from the traditional path toward “modernity” through Rostow’s well-established stages of development, including industrialization via textile and garments and other labour-intensive commodities, or through technological leapfrogging into services or skill-intensive capital goods. The CDSs have to identify and promote the type of industrialization which is best suited for the particular LDC. This type of search makes up a key component of the new functions of the CDS. Rather than taking industrialization as a given trajectory for all LDCs, the CDS “searches” (tries, experiments pragmatically) for the optimal path of development in its own economy, including choosing the optimal form of productive transformation, a process which requires policy space.

At early stages of development, the initiatives of the CDS will not rely solely on market forces to generate the desired structural change and economic transformation. In order to accelerate growth, the CDS will need to carry out significant shifting and reallocating of national and possibly international assets and resources to the growth-enhancing sectors. For this purpose, the CDS in LDCs should engage in a more strategic type of integration into the global economy, rather than pursuing rapid trade liberalization based on current and given comparative advantage. The CDS should assist LDCs in achieving an optimal degree of economic openness according to their own needs and circumstances, as well as the form of their integration into the global economy.

The CDS model is thus underpinned by a theory of openness within a managed trade policy that may enable a country to concentrate its relatively scarce resources in areas of production where world demand is highly income- and price-elastic; additionally from this analytical perspective, it needs to promote the diffusion of knowledge of the kind of learning needed for continuous upgrading of the quality of all of the local factors of production. Essentially, trade needs to be managed in order to gain all of the above-mentioned benefits, especially in the context of low income economies which are overly specialized on natural resources. Openness works positively only if the phenomenon of learning is suitably institutionalized on the policy side, involving appropriate government interventions that would make the domestic economy more responsive to change.

The success of the CDS will depend on effective development governance, and in particular the capacity to achieve and sustain high rates of investment

and to implement policies that encourage the acquisition and learning of new technologies. In all cases, the allocation of public investment is the primary function of the CDS, along with setting up of a pro-investment regulatory framework that would enable rapid catch-up growth that could accelerate economic development along the lines discussed in previous *Least Developed Countries Reports*. Moreover, the State needs legitimacy and to be a truly representative State, which will enable it to ensure a consensus for the development drive. This is a question of political will that involves what the *Report* calls “development contracts” or a social consensus in support of national development objectives.

THE CATALYTIC DEVELOPMENTAL STATE AND SOUTH-SOUTH COOPERATION

The benefits of South-South cooperation will be greatest when there is a dynamic two-way relationship in which South–South cooperation supports the building of developmental State capacities and the objectives of developmental States in LDCs, while the developmental State in LDCs in turn generates and augments the development impact of South-South cooperation. Action is required by both the LDCs and their Southern development partners to create positive synergies between the catalytic developmental State and South–South cooperation.

What LDCs can do

For LDCs, national ownership and leadership of policies are *sine qua non* for enhancing the development benefits of any kind of development cooperation, whether North–South or South–South. Mainstreaming South–South cooperation, both interregional and intraregional, into the national development strategies of LDCs is thus a necessary condition to ensure that South–South cooperation promotes rather than hinders the achievement of inclusive and sustainable development in LDCs. It is clear that, with current policies, globalization has not fostered the desirable kind of structural change in LDCs that could pull labour from less to more productive activities. A CDS would seek to use South–South cooperation to reshape integration into the global economy in way which would enable the structural transformations that are necessary for creating decent and productive employment opportunities and achieving substantial poverty reduction. The CDS in LDCs should also be

able to shape the integration into the global economy in a way that promotes learning and enhances resilience.

Although intensified South–South economic relationships are likely to become a central element of the approach of the CDS in shaping its strategic integration into the global economy, this should not be treated as a simple substitute for traditional North–South relationships. The latter remain crucially important for most LDCs. Thus, the challenge for LDCs is to maximize the development benefits of both North–South and South–South cooperation and to articulate them in a positive way. This is a daunting task, particularly given the different modalities of cooperation. However, the new opportunities associated with South–South cooperation should enable greater policy space for LDC governments.

To use this policy space effectively, it is important that LDCs develop institutions which allow them to integrate different forms of cooperation at the national level. As discussed in earlier *Least Developed Countries Reports*, one possible tool is the establishment of an aid management policy, which includes both an information system for tracking both North–South ODA flows and South–South official financial flows, as well as regular national forums in which LDC governments discuss with their cooperation partners the development effectiveness of their support.

What Southern partners can do

While LDCs themselves must exercise leadership to make the most of South–South cooperation, it is clear that South–South cooperation has certain features which can particularly support the building of developmental State capacities in LDCs and also help to overcome the constraints facing CDSs. Southern cooperation partners can best support the LDCs if their cooperation efforts accentuate these features.

Two features are particularly important.

Firstly, given the experience of major development partners in the South, South–South cooperation is more likely to support and encourage developmental State-building than traditional forms of development cooperation.

This can happen through three main channels: (a) supporting capacity-building efforts; (b) sharing policy lessons; and (c) providing alternative sources of finance.

The great potential for knowledge-sharing which supports policy learning and institutional experimentation in LDCs is rooted in the fact that all developing countries face similar challenges. Thus, even the largest dynamic Southern economies face problems with respect to poverty levels, technological gaps and non-level playing fields, similar to those which LDCs face, though to a much less severe degree. But on top of this, successful developing economies continue to formulate and implement developmental policies and to build developmental institutional arrangements. In short, policy-learning based on experiences from the more advanced developing countries may help LDCs to create new instruments and institutions to develop their productive capacities in a way which promotes structural transformation, employment generation and poverty reduction.

Policy learning can be encouraged in various ways, including (a) the organization of seminars and round tables; (b) sponsoring internships and visits of LDC officials in key development planning institutions and ministries; and (c) enabling academic exchange on development policies and strategies between research institutions and universities of LDCs and Southern partners. However, it should be noted that this requires resources and commitment. In general, technical capacity-building should be pursued as well as South–South policy dialogues to draw policy lessons from experience.

The provision of alternative sources of finance is another major channel through which South–South cooperation can support the building of the CDS in LDCs. Financing public investment, particularly in productive sectors and for physical and technological infrastructure, are critical functions of the developmental State. At present, the effectiveness of the State in LDCs is handicapped by a scarcity of public resources. Finance from other developing countries can directly enable policy initiatives in LDCs which do not correspond with the preferences of traditional donors. Moreover, new demand for natural resources from Southern partners can help to boost natural resource rents in LDCs, which can also support domestic resource mobilization. Helping to lift the financial resource constraint of LDC governments, either directly or through indirect effects on domestic resource mobilization, can be as important a form of South–South cooperation as helping to lift the technical capacity constraint through support for policy learning.

The second feature of South–South cooperation which is likely to be particularly supportive to LDCs is that building productive capacities has been much more integral to South–South cooperation than traditional development assistance. Thus, South–South cooperation can not only support developmental State–building, but also support the objectives of developmentally effective States.

There are three main channels through which South–South cooperation potentially supports the development of productive capacities in LDCs: (a) through official financial flows for production and economic infrastructure; (b) through investment and technology transfer and support for technological learning at the enterprise-level in LDCs; and (c) through the provision of preferential market access in a manner which permits, or even promotes, learning. Currently, the first is most important while the second and third are developing.

Although official financial flows from Southern partners to LDCs cover a wide range of activities, they tend to focus more on infrastructure and production sectors compared with traditional donors, who increasingly target the social sectors. The situation is particularly striking in Africa, where China, India and Arab countries are all active in the provision of infrastructure finance to African LDCs.

South–South technology transfer is also an important channel for developing productive capacities in LDCs. Technologies available in Southern countries are often more suitable to the needs and requirements of LDCs, at similar level of development, thereby confirming the scope for technology transfer. Moreover, the necessary human capital requirements for utilizing and adopting the new technologies, originating in the South, may be more absorbable, cost-effective, and generally more available in other developing countries than in the North.

One way in which Southern partners have been enabling learning in LDCs is through implementing specially-designed regional and bilateral free trade agreements in a way which provides LDCs with breathing space — extra time to liberalize — so that they have the time to help their domestic enterprises develop necessary capabilities to compete. In recent years, various Southern countries have started preferential trade schemes for LDCs in the form of duty-free, quota-free market access provisions. A critical issue is whether these schemes will provide a training ground for LDC enterprises to upgrade

production. As discussed in the Report, this is not likely to be automatic. Thus, designing these schemes in such a way that can realize the nascent potential of South–South trade to support learning and upgrading is important.

The importance of mutual advantage

While a dynamic relationship can be established between CDSs in LDCs and South–South cooperation, it is clear that, for this to occur in practice, the relationship between LDCs and their Southern partners should not only be valuable to the former but also lead to mutual advantage.

In this regard, the fundamental principles of solidarity and mutual respect which underpin South–South cooperation are important. Given their shared histories of colonialism and neo-colonialism, similar initial conditions and familiar economic and political constraints, there are strong reasons to believe that South–South cooperation and integration can avoid reproducing the asymmetries and biases that have overshadowed traditional development cooperation. However, South–South cooperation should not be thought of as a panacea for development and should not be romanticized. While the donor–recipient relationship characteristic of aid and development is absent in the context of South–South cooperation, this does not mean that all can participate on an equal basis. South–South trade, investment and development aid also include both complementary and competitive relations between the domestic interests of LDC nations and those of investors and exporters from more advanced developing countries.

Nevertheless, it is possible to identify a number of reasons why Southern partners may be motivated to engage in the types of cooperation suggested above and mutual advantages obtained with LDCs. In particular:

- There is a potential to create mutually beneficial market gains and opportunities for both partners. South–South cooperation should be seen as a policy tool that can facilitate the building of new markets both in terms of production and consumption.
- LDCs offer access to natural resources that their Southern partners need. Southern investment in LDCs in exploitation of these resources can be mutually beneficial for both parties provided the policy framework focuses on its developmental impact in LDCs.

- Regional prosperity and regional stability cannot be achieved without the participation of all the countries in the region, including the LDCs. Strategic geopolitical interests also play an important rational that provides motivation for cooperation with LDCs.
- Finally, it is clear that the LDCs can work jointly with Southern partners to better articulate their common voice and exercise its collective influence in all forums. Other Southern partners could also gain from broadening the voice and participation of a larger membership of countries, in order to better articulate the needs of developing countries in general.

DEVELOPMENTAL REGIONALISM

Developmental regionalism is an important mechanism through which the CDS and South–South cooperation can reinforce each other. Developmental regionalism is understood here as a development-led regionalism that accepts globalization as a historical trend, but rejects the market-led approach to globalization. Developmental regionalism aims at maximizing the benefits of regional cooperation with the goal of achieving an advantageous insertion of the members’ economies into world markets. This goal is not an end in itself, but only a means to accelerate economic, social and human development.

Developmental regionalism is concerned with both (a) internal economic development and domestic integration, while at the same time, with (b) strategic integration of the regional trading blocs into the world economy. As it is the case with other forms of regionalism, the most basic level of cooperation covered by developmental regionalism is that of trade. Most LDCs lack a sufficiently large and diverse home market, (that could allow diversification of the industrial structure) and thus regional markets provide an important economic space within which learning over time can take place.

However, the concept of developmental regionalism goes beyond the domain of trade *per se*, and includes other, more ambitious forms of intervention, such as industrial policy. There are major opportunities for the achievement of economies of scale through the provision of various kinds of regional public goods which would benefit LDCs and other developing countries within regional groupings. Such regional public goods include various kinds of physical infrastructure supporting transport, communications and energy, as well as regional science and technology infrastructure and regional innovation systems.

In addition, with regard to the agricultural constraints to development in LDCs, reflected in their inability to generate surplus and to guarantee food security for all, joint adaptive research with neighbouring countries, regional storage facilities and coordinated investment programmes at the regional level can all make a difference. Financial deepening can also have a strong regional dimension through regional development banks, as will be discussed in more detail below. What all this can add up to is a type of regional industrial policy which can involve a variety of policy tools, and not only those traditionally associated to trade policies proper — from tariff and non-tariff barriers, to subsidies, concessional loans, direct provision of infrastructure and other public goods, promotion of research and development and science and technology activities, State-owned enterprises and State-controlled mixed enterprises, and many others. For greatest impact and efficiency, these policies should be harmonized and coordinated among participating countries in the regional association.

Under developmental regionalism, trade amongst regional partners is favoured with respect to extraregional trade, implementing strategic trade policies consistent with each member State's domestic industrial policies. Strategic trade policies may include traditional or less traditional tools — such as tariffs, import and export quotas and bans, technical and phytosanitary standards. In tandem with its holistic vision of development, regional trade can also be promoted through coordination of investment to strategic areas such as regional transport and other ancillary infrastructure. Prioritizing investment in strategic areas of common interest and common constraints can help to overcome the pre-existing bias against regional trade caused by the colonial legacy that characterizes many LDCs and other poor countries.

The *Report* discusses various successful examples of developmental regionalism, particularly in Asia, which illustrate the potential. These include trilateral cooperation between China, the Republic of Korea and Japan on developing new technologies and the catalytic role of the Asian Development Bank and the Brunei Darussalam–Indonesia–Malaysia–Philippines East Association of Southeast Asian Nations (ASEAN) Growth Area. Another important example is the development of economic corridors within the Greater Mekong Subregion, that is coordinated by the Asian Development Bank. This involves the development of economic corridors, which cover Cambodia, the Lao People's Democratic Republic and Myanmar and promise to link them more closely economically with their neighbours. However, past experience shows that the benefits of regionalism can be unequally shared.

Thus, the *Report* argues that LDCs will benefit more through a policy of regional integration which involves an integrated regional development approach linking trade, finance, investment, technology and employment policies and also, where necessary, through specific regional support measures.

Leveraging South–South financial cooperation for LDCs’ development

The *Least Developed Countries Report 2011* provides a practical application of this policy framework. It focuses on one of the most fundamental challenges in implementing the new IPoA for LDCs, namely mobilizing financial resources and directing them to productive use in a way which leads to sustainable and inclusive growth and development.

The *Report* argues, firstly, that regional and subregional development banks should play a larger role in supporting LDCs and also financing developmental regionalism. It then goes on to make a proposal aimed at mobilizing untapped resources from Southern partners in order to boost the provision of development finance through regional and subregional development banks. The central idea underlying this proposal is to channel a very small proportion of the foreign exchange reserves increasingly held by developing countries towards regional and subregional development banks. These banks would, in turn, intermediate these financial resources in support of development-oriented investments in the provision of regional, and also national, public goods which would enable the LDCs to build and strengthen their productive capacities.

As expressed in the IPoA, the policy suggestions should not be seen as a substitute for North–South development assistance. They are rather intended to improve the diversity and efficacy of development financing in LDCs. Although the proposals would generate additional external resources considering their implementation, it is also necessary to take account of the development challenges facing southern partners, and their capacity.

THE ROLE OF REGIONAL DEVELOPMENT BANKS

Regional financial cooperation covers a wide spectrum of activities, including (a) regional payments systems which provide financial incentives to

intraregional trade; (b) regional monetary systems which can provide liquidity finance to cushion against external shocks; and (c) regional and subregional development banks which provide long-term finance — development finance — to support private and public investment.

Revitalizing and strengthening the role of regional and subregional development banks is an important component of the agenda of reforming the international financial architecture and such banks should play an increasing role in financing development in the LDCs. Important regional development banks for LDCs at the moment include (a) the Inter-American Development Bank, created in 1959; (b) the African Development Bank, created in 1964; and (c) the Asian Development Bank, created in 1966. In general, the regional and subregional development banks in Asia and Latin America supply a much greater share of total multilateral ODA within their respective regions than the regional and subregional development banks in Africa do. Also, regional development banks provide a relatively low share of total multilateral ODA disbursements to LDCs.

There are a number of advantages of regional and subregional development banks. First, because of their regional ownership structure, regional development banks can facilitate a stronger voice to developing country borrowers, as well as enhance regional ownership and control. Second, they can be more effective because they tend to govern more through informal peer pressure rather than imposing conditionality. Third, information asymmetries are smaller at the regional level, given proximity as well as close economic and other ties. In this regard, it has been proposed that there should be a conscious effort to translate the principle of “subsidiarity” into the practice of development finance. That is, where development investments aspire to global or transregional objectives, there is an obvious rationale for a global institution to play the dominant role. But where investments seek to meet national or regional objectives, there is less need for a global institution to be the key player. Accumulation of development-related knowledge and expertise better occurs and is utilized closer to the ground. Regional or subregional development banks can be particularly valuable for small and medium-sized countries such as LDCs, which are unable to carry much influence in global institutions. Their voice can be better heard and their needs better met by regional and subregional institutions, rather than by global institutions.

Regional and subregional development banks may also be particularly suitable for provision of regional public goods. Since industrial development

occurs increasingly within regional production networks, the provision of “social overhead capital” — such as infrastructures, energy, or telecommunication networks — at the regional level is likely to become more and more critical. Regional development banks, in this context, appear to be the most appropriate institutions to oversee the financing and implementation of such large-scale investments projects, while ensuring that the interests of even the smallest country involved are adequately taken into account.

However, for maximum success it is important that regional development banks’ activities do not take place in a policy vacuum. They need to become an integral part of a broader developmental regionalism framework, supported by a catalytic developmental State. Indeed they should be regarded as a key instrument of developmental regionalism through which the benefits of integration accrue to least developed member countries. Moreover, an important factor affecting the working of both multilateral and regional development banks is their ownership structure. Some regional banks have both developed and developing country members, in varying proportions; others, notably subregional development banks such as the Andean Development Corporation, have a membership composed almost exclusively of developing countries. This matters because banks tend to respond to the political agendas of their major shareholders.

Experience indicates that regional and subregional banks have worked particularly well where their shareholders are also their clients. One good example is the European Investment Bank. It provided a significant financial mechanism to make economic integration in Europe equitable, providing grants and guarantees for building regional infrastructure in less developed areas. The Andean Development Corporation is also a good example. It is a regional development bank exclusively owned by developing countries and its features include the great average speed with which loans are approved, and the absence of conditionality.

At present, non-borrowing countries still have a strong position in most regional development banks. However, if an increasing share of regional development banks’ financial resources comes from Southern countries, the relations of power inside the regional development banks is likely to change, with Southern countries being entitled to much higher quotas of capital and more governing board members. Such a change in the legal ownership of regional development banks could in itself powerfully enhance the sense of political ownership of the programmes and projects financed by the banks on the part of beneficiary countries.

SOVEREIGN WEALTH FUNDS AS POLICY TOOLS TO PROMOTE SOUTH-SOUTH COOPERATION: A PROPOSAL

Between December 2001 and the end of 2010, the value of global reserves increased from \$2.05 trillion to \$9.30 trillion. The bulk of the increase was due to reserves accumulated by developing countries which, as a whole, accounted for more than 80 per cent of global reserve accumulation during this period. By the end of 2010, their reserves approached \$6.1 trillion. Part of these reserves were held by commodity exporters, oil exporters in particular, who have been accumulating foreign exchange holdings thanks to the boom in commodity prices. Another part was by large and medium-sized manufacturing exporters, who have enjoyed trade and current account surpluses for many years. The latter group is made up by a small number of Asian developing countries.

Such an extraordinary process of reserve accumulation is without parallel in recent history. A significant proportion of those assets has been accumulated in Sovereign Wealth Funds, (SWFs), which are generally run independently from traditional reserve management by central banks and/or finance ministries. Total SWF assets were estimated in March 2011 to be valued at \$4.3 trillion, of which \$3.5 trillion were owned by developing and emerging countries, including \$7 billion by three LDCs — East Timor, Kiribati and Mauritania.

Without underestimating the economic, institutional and political difficulties that such an initiative would entail, one promising way in which Southern countries could strengthen the role of regional financial institutions could be through channelling towards them a very small share of the financial resources presently managed by their SWFs. This proposal would provide the SWFs with an opportunity to diversify their long-term financial position — currently held mainly in developed countries. Moreover, SWFs could enhance the regional development banks' capacity for long-term lending and provide them with opportunities to match their long-term assets to long-term liabilities.

Assessing the viability of such initiative is beyond the scope of this *Report* and would require a full-fledged feasibility study; however, a “back-of-the-envelope calculation” suggests that this strategy could boost significantly the role of regional development banks, leading to large increases in the availability of development finance. If only 1 per cent of Southern SWF assets were invested into regional development banks, for example, this would

increase their paid-in capital by \$35 billion. Assuming a conservative ratio of authorized capital to paid-in capital of 2.8, this would translate into an additional \$98 billion of authorized capital, corresponding to an additional annual lending capacity of over \$84 billion. This figure would be higher than the total lending disbursements to developing countries by all multilateral and regional development banks — including the World Bank and the European Investment Bank — in 2009, the year when their lending activities peaked (at \$64 billion) due to the extraordinary credit requirements caused by the global financial crisis.

A similar boost in regional development banks' lending capacities could clearly play a central role in financing the provision of region-wide infrastructures (thereby facilitating regional trade integration), as well as supporting the development of domestic productive capacities, particularly in the LDCs.

Two important caveats must be taken into account, however, when promoting the development of South–South financial cooperation. First, it is important to distinguish the growing opportunities for South–South financial cooperation from the longstanding responsibilities underlying the traditional development cooperation framework. South–South financial cooperation should be viewed as a complement, rather than as a substitute for, traditional North–South cooperation. The second caveat is that it is important that Southern partners can actively use this new modality for mutual advantage. Increased financial support should go hand-in-hand with increased voice in the governance of regional development banks.



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