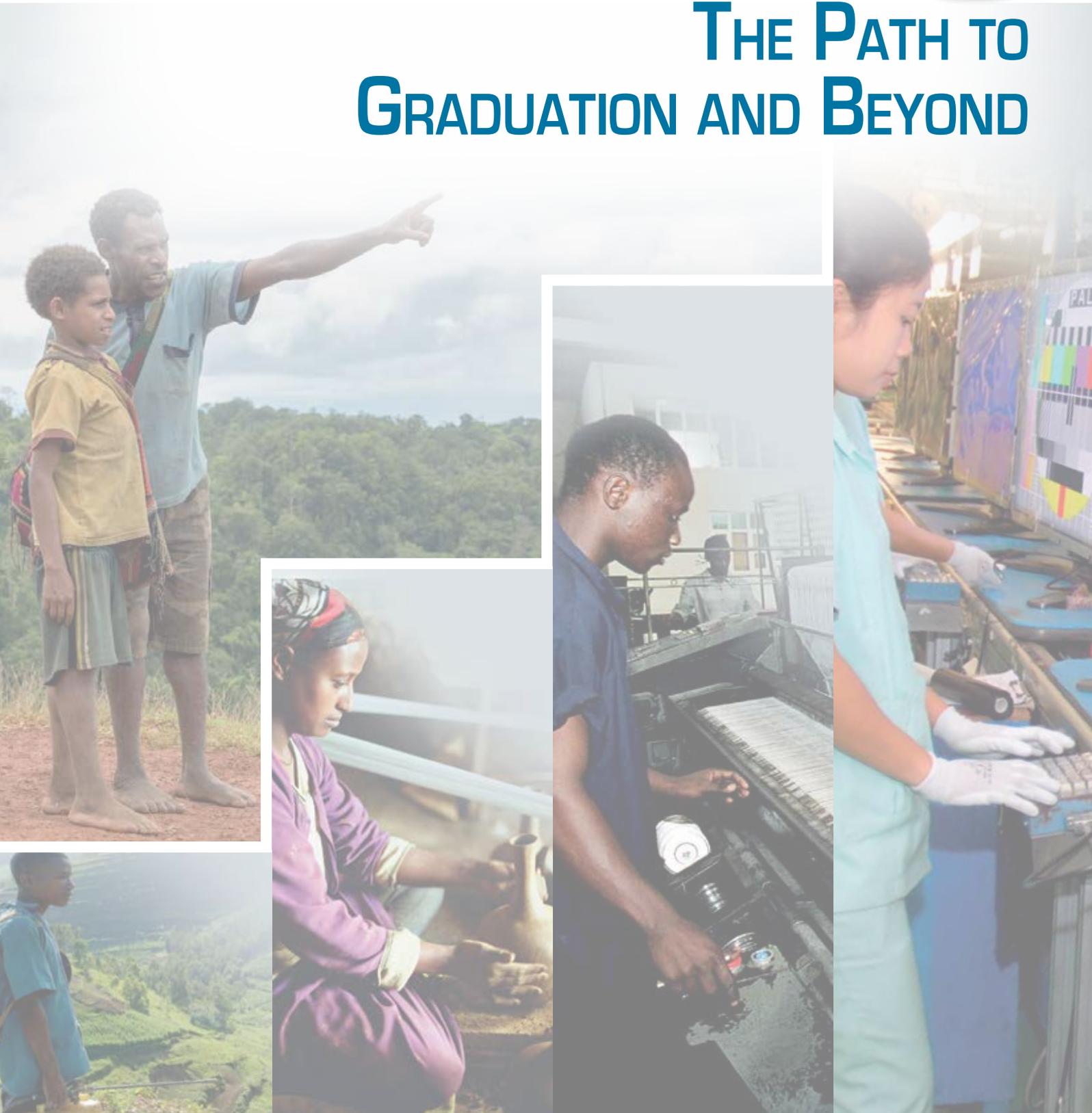




THE LEAST DEVELOPED COUNTRIES REPORT 2016

The path to graduation and beyond: Making the most of the process

CHAPTER 5 THE PATH TO GRADUATION AND BEYOND



A. Introduction

The 2011 Programme of Action for the Least Developed Countries for the Decade 2011–2020 (the Istanbul Programme of Action (IPoA)) included a target that half of the 49 countries with least developed country (LDC) status at the time should meet the statistical criteria for graduation by 2020. This was the first time that the international community had adopted an explicit target for graduation from the LDC category. Now, halfway from the setting of the target to the date for its attainment, it seems clear that it will not be met. The projections presented in chapter 2 of this Report suggest that only 16 (one third) of the current LDCs (in addition to Samoa, which graduated in 2014) can be expected to satisfy the full graduation criteria by 2021. This suggests that policies at the national and/or international level — that is, national graduation strategies and/or the international support measures (ISMs) for LDCs — have so far fallen significantly short of the expectations of the IPoA.

Several LDCs will meet the graduation criteria by 2021, but it seems clear that the IPoA graduation target will not be met.

However, this Report has argued that approaches to graduation should go beyond the minimum requirement — fulfilment of the statistical criteria (as discussed in chapter 1) — to aim for the more ambitious, but more substantive and sustainable, goal of “graduation with momentum”. LDCs should seek not merely to qualify for graduation, but also to establish the essential foundations for their subsequent development, to avoid the traps and pitfalls of the later stages of the development process. It seems clear that not all of those countries that are projected to meet the statistical criteria for graduation by 2021 will have achieved this. While they may graduate by 2024, they may thus expect to remain subject, to some degree, to some of the structural weaknesses and vulnerabilities characteristic of LDCs even after graduation.

This raises the question of what can and should be done at the national and international levels, not only to accelerate progress towards graduation in line with the IPoA target, but also to ensure that those countries that reach graduation do so with the momentum needed to sustain them through the post-graduation development process. This is the theme of the present chapter. Following a further elaboration of the concept of graduation with momentum (section B), the chapter sets out elements of “graduation-plus” strategies to achieve this (section C). It then analyses how the international community can support such a process, both by ensuring a conducive global economic environment (section D) and by establishing effective ISMs (section E). The chapter concludes with a discussion of issues which might usefully be considered in reviewing the LDC criteria (section F).

How a country graduates is as important as when, to allow it to engage in global markets on an equal footing with ODCs.

B. Graduation with momentum

A recurrent theme throughout this Report has been the concept of graduation with momentum. This highlights the importance of viewing graduation as the first milestone in a marathon of development rather than the winning post in a race to escape LDC status,¹ and of focusing primarily on longer-term development processes rather than on the technicalities of the graduation criteria. While several countries close to the graduation thresholds have adopted graduation as a major national goal, as discussed in chapter 2, it is important that this is seen only as an initial step. The country’s development process continues indefinitely beyond this point, and its subsequent success depends critically on the foundations built in the course of graduation. How graduation is achieved is thus as important as when it is achieved.

When an LDC graduates, it should have escaped from the vicious circles discussed in chapter 1 sufficiently to engage in international markets on an equal footing with other developing countries (ODCs), without relying on LDC-specific ISMs, for which it will no longer be eligible. As discussed in chapter 2, however, the extent to which the statistical criteria for graduation capture a country's ability to do this is open to debate. For example, none of the countries that have graduated to date has even now attained the graduation threshold for the economic vulnerability index (EVI), the graduation criterion that most closely reflects structural vulnerabilities (chapter 4). Thus, policies leading to graduation should not be aimed narrowly at achieving statistical eligibility, but rather oriented towards broader developmental goals. Equally, fulfilment of the criteria should be viewed, not as an object in itself, but rather as a by-product of an effective strategy oriented towards graduation with momentum. It is noteworthy that none of the four countries that have graduated from the LDC category to date adopted graduation as an explicit development goal (chapter 2). Rather, their actions towards graduation were essentially taken in response to recommendations of the Committee for Development Policy (CDP) and the initiation of the graduation process.

Productive capacities and structural transformation are critical to graduation and beyond...

UNCTAD's *Least Developed Countries Report* series has long ascribed LDCs' weak economic and social performance and persistent vulnerability to exogenous shocks to the limited development of their productive capacities (diversification and increasing sophistication of their productive bases) and slow and unbalanced processes of structural transformation (increasing productivity and reorientation of production from low-value-added to high-value-added sectors and activities). These shortcomings seriously limit LDCs' ability to derive developmental benefits from integration into the international economy (UNCTAD, 2006, 2014a). Their situation is aggravated by a volatile and often unfavourable international economic environment; and the existing ISMs have proven inadequate to counter these problems (UNCTAD, 2010). It is this combination of domestic and international shortcomings that has driven the divergence between the LDCs and ODCs documented in chapter 1 of this Report.

...but so far this is not fully captured in the statistical criteria for graduation.

Thus the keys to ensuring sufficient momentum at the point of graduation are the development of productive capacities and structural transformation of the economy. These are the primary means of redressing LDCs' structural handicaps (such as the poverty trap, the commodity-dependence trap and balance-of-payments constraints to growth, all examined in chapter 1), of coping with the adverse effects of geographical factors such as remoteness and landlocked location, and of establishing a more sustainable long-term development path. This emphasis is also closely aligned with the avowedly transformative 2030 Agenda for Sustainable Development (2030 Agenda), which includes explicit targets for both structural transformation and industrialization, and places greater emphasis on the interconnectedness of the economic, social and environmental pillars of sustainable development than did the Millennium Development Goals.

Beyond graduation, the possibility of falling into the "middle-income trap" (discussed in chapter 4) highlights the continuing importance of structural transformation and continuous development of productive capabilities throughout the course of development. This is further reinforced by global value chains (GVCs), which tend to realign patterns of trade and investment flows to divide production processes into ever-smaller segments based on existing comparative advantage, rather than fostering a *dynamic evolution* of comparative advantage (UNCTAD, 2015a: paras. 35–41).

Graduation with momentum is of particular relevance to those countries projected to graduate via the income-only route (Angola, Equatorial Guinea and Timor-Leste), whose remarkable growth performance during the commodity

Graduation with momentum can offset the costs of losing access to LDC-specific ISMs...

super-cycle has led to little economic diversification or generation of productive employment. Such a trajectory provides at best a weak foundation for future development. Unless it is effectively directed to the development of productive capacities and economic diversification, even the sizeable wealth accumulated through fuel extraction may provide limited resilience to exogenous shocks. This has been highlighted by the sharp downward revisions of estimates for these countries' economic growth following the recent fall in commodity prices.

Three factors may make the concept of graduation with momentum particularly appealing to LDC policymakers. First, while the costs of graduation arise directly from the graduation process itself, as ISMs are phased out at the end of the smooth transition period, its benefits arise from the improvement in socioeconomic conditions that underlies graduation. For example, the fact of graduation often entails some loss of preferential market access; but it is primarily the development progress underlying graduation that increases the country's capacity to mobilize domestic resources, to strengthen its financial system and to direct financing to productive investment. Thus, the extent of real development progress underlying graduation is an important determinant of the balance of its impacts.

...strengthen social and political coalitions in support of the country's development strategy...

Second, as can be seen from the past cases of graduation, it is a moment of national pride, conferring international recognition on the country's long-term developmental vision, and potentially strengthening the social and political coalitions supporting it. While the technicalities of the graduation process are remote from the general public, the inclusiveness of the pattern of growth leading to graduation plays a key role in ensuring its sustainability (UNCTAD, 2013a). By generating employment (particularly in non-traditional sectors) and raising incomes, policies aimed at economic diversification and productive-capacity development are likely to be more inclusive, and thus to engender greater domestic support.

...and help to address challenges and shocks beyond graduation.

Third, graduation with momentum is critical to addressing development challenges and coping with shocks in the post-graduation phase, after access to LDC-specific ISMs has been lost. As emphasized in chapter 4 of this Report, structural transformation, productivity growth and increasing sophistication of the economy are the driving forces behind convergence towards higher income levels throughout the course of development. They are thus of continued importance beyond graduation, to avoid the middle-income trap and build resilience to growth slowdowns, particularly in a context of continued geographical and/or structural vulnerability to economic and environmental shocks. Such vulnerability is highlighted by the experiences of past LDC graduates: while they have sustained their development trajectories without major disruptions since graduation, there are indications of persistent vulnerability, including rising debt levels, limited economic diversification, volatile official development assistance (ODA) flows, and in most cases moderate or high levels of poverty.

C. "Graduation-plus" strategies for graduation with momentum

National development strategies play a central role in "graduation-plus" strategies.

A more conducive international environment and more effective ISMs are critical to graduation with momentum (see sections D and E below). Nonetheless, as the Addis Ababa Action Agenda of the Third International Conference on Financing for Development emphasizes: "each country has primary responsibility for its own economic and social development and ... the role of national policies and development strategies cannot be overemphasized" (United Nations, 2015: para. 9). It is thus incumbent upon the policymakers of each LDC to assume

full ownership of their country's development agenda, making the most of their respective circumstances and redoubling their efforts to leverage the existing ISMs effectively.

The key importance of attaining graduation with momentum, rather than merely satisfying the statistical criteria, indicates a need to move from graduation strategies to "graduation-plus" strategies centred on a longer-term perspective and laying the foundations for the continuing development process. Such strategies should thus focus on the need for structural transformation, both before and after graduation, and apply different instruments and planning techniques to address the macroeconomic and sectoral challenges of development.

A logical starting point for such strategies is to determine the factors that constrain the country's growth and to identify potential products and sectors of specialization and comparative advantage.² This can provide the starting point for the design and implementation of policy actions and programmes to overcome the former and to foster development of the latter. The international dimension of such an exercise can be addressed by the diagnostic trade integration studies produced under the aegis of the Enhanced Integrated Framework (EIF). The strategies, policies and programmes generated by these processes should be embodied in a long-term national development plan aligned with the Sustainable Development Goals, as a basis both for medium-term plans such as Poverty Reduction Strategy Papers and for donor alignment. UNCTAD's "Specializing smartly" toolkit can provide an important source of technical assistance (UNCTAD, 2016a).

An important part of graduation-plus strategies is an assessment of the country's use of ISMs and the constraints to more effective exploitation of the opportunities they provide, to optimize the utilization and developmental impacts. It is also important to plan for the phasing-out of access to these ISMs following graduation, including through the identification of alternatives (for example, non-LDC-specific preferential market access instruments).

It should be emphasized that the policies adopted as part of a graduation-plus strategy in any country must reflect its own particular circumstances and priorities and be adapted to its institutional framework and capacities, as one-size-fits-all approaches may be counterproductive. Nonetheless, some types of policies can be identified as being of particular relevance to graduation with momentum, having been identified in previous editions of *The Least Developed Countries Report* as fundamental to accelerating the development of productive capacities through capital accumulation, technological progress and structural change (UNCTAD, 2006: chap. II.1). While such policies are closely interrelated in their contribution to graduation with momentum, they are grouped into six broad areas for presentational purposes: rural transformation; industrial policy; science, technology and innovation (STI); finance; macroeconomic policy; and employment generation. Gender is also a key issue, cross-cutting these and other policy areas.

1. RURAL TRANSFORMATION

Rural development is a critical dimension of structural transformation in LDCs. Two thirds of the LDC labour force is employed in agriculture, which also plays a critical role in the supply of inputs and wage goods, and in domestic demand for the output of other sectors. In the context of the 2030 Agenda, the importance of rural development is further increased by its role in Sustainable Development Goals 1 ("End poverty in all its forms everywhere") and 2 ("End hunger, achieve food security and improved nutrition and promote sustainable agriculture"). An accelerated and broadly based transformation of rural economies is thus

"Graduation-plus" strategies are needed, focusing on graduation with momentum...

...starting from a diagnosis of constraints to growth and identification of economic opportunities...

...and optimizing use of ISMs.

Key areas of "graduation-plus" strategies are rural transformation, industrial policy, STI, finance, macroeconomic policy, employment and gender.

central to the process of poverty-oriented structural transformation essential to achieving the Goals (UNCTAD, 2015b).

Redressing chronic underinvestment in agriculture is a key priority for most, if not all, LDCs. With due consideration of each country's specific needs, this is likely to require a combination of the following mutually supportive elements:

Rural development requires redressing chronic under-investment in agriculture...

- Appropriately sequenced investment in key elements of infrastructure, notably electrification, irrigation, drainage, water supply, storage facilities and road networks;
- Upgrading farming technologies and practices, to enhance productivity and sustainability;
- Financing research on improved and more resilient seeds and cultivation techniques, and deploying extension services throughout agricultural areas to provide technical assistance and foster the adoption of such seeds and techniques, particularly by under-resourced small producers;
- Actively assisting smallholders or producers with limited access to finance and technology in raising their productivity and upgrading their production, for example through support to producers' associations and cooperatives, programmes to improve access to credit and appropriate land-titling policies.

...and it results in diversifying rural economies through promotion of non-farm activities.

For certain agricultural products, it may be beneficial to complement support for local transformation with dedicated technical assistance to allow small producers to connect to GVCs on more favourable terms, as in the case of Ethiopian coffee producers under the Ethiopia Trademark and Licencing Initiative (Balgobind, n.d.). In this context, graduation with momentum is also likely to require measures to redress the limited availability of skills, for example through appropriate vocational training schemes and initiatives to match school curricula with the market's needs.

Diversification of the rural economy through the promotion of rural non-farm activities also plays an important role, given the complementarities between agriculture and the rural non-farm economy. It provides a source of demand for agricultural outputs and of finance for agricultural investment; facilitates the supply of agricultural inputs; and can increase the tradability of agricultural produce and provide opportunities for greater value addition.

There is scope for both "vertical" and "horizontal" industrial policies to tackle market failures.

The development of non-farm activities also allows producers to diversify their income sources beyond agriculture, to smooth their incomes over time (particularly across seasons), and to diversify risks related to their productive activities. It can thus also help to reduce risk aversion, which is a major impediment to agricultural investment and technological innovation. Coordinated measures to promote rural non-farm activities in tandem with agricultural upgrading, maximizing the synergies between the two, can thus play a critical role in rural development strategies. These measures include the mutually supportive elements listed above with policies to support rural entrepreneurship by choice (rather than by necessity) and the creation of employment through rural infrastructure works (UNCTAD, 2015b).

2. INDUSTRIAL POLICY

There is a growing consensus that structural transformation does not occur automatically, but rather requires proactive policy action to address the widely recognized obstacles to the shifting of production to new sectors and activities with higher productivity and greater technological potential. This also relates to the spillovers, informational asymmetries and coordination issues that impede innovation and price-discovery processes (UNCTAD, 2010, 2014a, 2016d;

UNECA, 2015a). In this context, there is scope for both “vertical” (sectoral) and “horizontal” (functional) policies to tackle specific market failures across sectors. By beginning from the country’s existing capacity, and fostering the emergence of backward and forward linkages, such policies can contribute significantly to increasing value addition. Bolder and more strategic industrial policy frameworks, including in STI (subsection 3, below), could also enable LDCs to harness more fully such policy space as is available to them.

In seeking to “nudge” producers to move from lower- to higher-productivity sectors, LDC policymakers need to strike a balance between exploiting more intensively those productive activities that are consistent with current comparative advantage and encouraging the expansion of activities at progressively higher levels of sophistication. This represents a combination of what have been called “passive” with “active” industrial policies (UNCTAD, 2016d: chap. VI). A second challenge is to devise industrial policy strategies in such a way as to ensure that support for emerging activities does not promote rent-seeking behaviours. Potentially useful approaches to this issue include (a) sunset clauses, to ensure that support does not become entrenched; (b) a combination of “carrots” and “sticks”, penalizing losers as well as rewarding winners; and (c) institutional arrangements that ensure a high degree of accountability in the conduct of industrial policy.

Industrial policies need to strike a balance between current comparative advantage and increasing sophistication.

3. SCIENCE, TECHNOLOGY AND INNOVATION POLICY

Structural transformation in LDCs requires building capabilities in STI, which are critical to closing the productivity gap between LDCs and more advanced economies. Such capacities play two distinct roles. First, they contribute to a catching-up process, increasing efficiency in the use of productive resources by moving production processes closer to the technological frontier, and thus also improving competitiveness. Second, they play a fundamental role in fostering the emergence of new activities that offer high value-added and growth potential, allowing the country to reap the benefits of dynamic gains from trade. These processes occur through a combination of absorption and adaptation of imported technologies and development of indigenous technological capacities.

STI capabilities are needed to absorb, adapt and develop technologies...

However, this process is far from spontaneous, and requires a conducive policy framework. A key objective of such a framework is to increase capacity for the absorption of more sophisticated technologies imported or transferred from other countries and to adapt them to local conditions. This can help LDCs to reap some of the strategic opportunities offered by technology-related ISMs, such as the extension of the transition period for their implementation of the World Trade Organization (WTO) Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS Agreement) and support for technology transfer under the Agreement’s article 66.2 (see section E.4 below). Increasing capacity for absorption and adaptation of imported technologies requires, inter alia, the development of a pool of skilled and talented labour through vocational training, tertiary education and competence-building, especially in engineering, science and mathematics.

...which requires a conducive policy framework.

In the Addis Ababa Action Agenda, governments committed themselves to adopting STI strategies as an integral element of their national sustainable development strategies, and to crafting policies to incentivize the creation of new technologies and research and to support innovation (United Nations, 2016b). Given the interconnection between STI policy and industrial policies, this requires an integrated approach to the two areas, to promote the emergence of viable and progressively more sophisticated activities, notably in manufacturing and modern service sectors.

STI tends to be a neglected policy area in many LDCs.

However, STI tends to be a neglected policy area in many LDCs. Moreover, the objectives of fostering innovation and promoting structural transformation have often been pursued by different institutions with weak coordination, resulting in gaps, redundancies and inconsistencies in industrial and STI policies (UNCTAD, 2015c). The experiences of several LDCs highlight the need for a more strategic approach, in order to boost absorptive capacities and harness intellectual property to promote radical innovation and technological leap-frogging (UNCTAD, 2012a, 2015c; UNECA et al., 2016). However, technological learning and innovation need to be appropriate to each country's level of technological development, its economic structure and the capabilities of its public institutions and private sector (UNCTAD, 2007).

While the policies appropriate to each LDC are clearly dependent on its particular circumstances, some general observations may be made, particularly in terms of priorities and institutional arrangements.

In order to be effective, STI policies need to be coordinated with policies in other areas, including education, competition, regulation, tax, development finance, international trade, investment and public-sector management. Effective coordination is thus important to improve policy coherence in the conceptualization and design of STI policies, to articulate their linkages to the country's broader development vision, and to integrate them effectively with industrial and other policies.

STI capabilities also depend on the quality of interactions among actors in the innovation system.

STI capabilities depend not only on the existing stock of technological knowledge, but also on the quality of interactions among actors that are part of the innovation system, particularly between institutions of research and advanced education and domestic and foreign firms, to improve absorptive and innovative capacities (United Nations, 2016a). Measures to strengthen such interactions at an economy-wide level might include, for example, the creation of national online knowledge and learning resources to allow enterprises, researchers and domestic and foreign universities to interact and exchange ideas, and to network on STI-related issues. National intellectual property systems can encourage national firms and advanced educational institutions to engage in technological learning and local research and innovation. Sector-specific initiatives to foster technology transfer, incentivize joint ventures, and promote closer collaboration between domestic firms and foreign investors can also make a major contribution, by increasing domestic value addition and strengthening backward and forward linkages (UNCTAD, 2012a).

Regional and South-South cooperation can play an important role in STI strategies, as well as ODA.

As well as ODA, regional and South–South cooperation can play an important role in STI strategies. Pooling scarce resources, at regional and/or subregional levels, could allow the establishment of joint research and technology incubator facilities and the implementation of joint research projects. This has been done in the agricultural sector through research institutes coordinated by the Consultative Group on International Agricultural Research, such as AfricaRice, the International Institute of Tropical Agriculture, the International Livestock Research Institute and the International Maize and Wheat Improvement Center. In all these cases, LDCs participate in the research efforts and derive benefits from research results.

Equally, there are growing opportunities for South–South technology transfer. Knowledge flows and technical cooperation have become major components of South–South economic relations, diversifying the sources of knowledge transfer and partnership for LDCs (UNCTAD, 2010: chaps. 4, 7; UNCTAD, 2012a). South–South technology transfer is complementary to North–South knowledge flows, the two sometimes being combined in triangular cooperation, whereby South–South knowledge flows are facilitated and boosted by developed country donors (UNDP, 2009).

4. DEVELOPMENT FINANCE

Finance plays a fundamental role in productive-capacity development, mobilizing domestic and foreign resources and intermediating them in support of transformative productive investment and technological upgrading (McMillan et al., 2014). The need to reinforce domestic resource mobilization, strengthen the fiscal base of LDCs and curb illicit international financial flows has been repeatedly stressed, both by UNCTAD (2014b, 2015d) and by the international community as a whole (for example, in the Addis Ababa Action Agenda).

For most LDC firms, the bulk of investment financing is initially from internal resources. However, to grow and upgrade their productive capacities, firms need to shift towards bank financing, which requires an efficient banking system. Development banks and central banks have an essential role in ensuring that finance is available for long-term investment, as it is only at higher levels of dynamic growth and development that a profit-investment nexus can be established (UNCTAD, 2016d: chap. V). This process also strengthens the country's attractiveness to foreign investors, through its effects on determinants of foreign direct investment (FDI) allocation such as macroeconomic fundamentals, institutional factors and cost competitiveness.

A greater transformational impact is likely to be achieved through development banks, which can foster agricultural modernization and industrial upgrading, following the model of some newly industrializing countries (UNCTAD, 2015b, 2015d: chap. VI). Their role in financing long-term development and structural transformation has been recast in a more positive light since the outbreak of the financial and economic crisis of 2008 (Griffith-Jones et al., 2016a). Ethiopia has long made use of its national public development bank (the Development Bank of Ethiopia) to provide long-term credit (for example, to manufacturing and structural transformation), contributing to the country's structural transformation (Griffith-Jones et al., 2016b).

There is also scope to strengthen the surveillance and regulatory framework of the financial sector, to enhance trust and mobilize savings more effectively. Improvements to the overall institutional framework underpinning the credit market — for example, improving credit report systems and property titling — may also help to broaden credit provision by reducing risks to lenders.

Despite accelerated progress in recent years, largely as a result of mobile banking systems, financial inclusion remains very limited in most LDCs. Many people remain unbanked, particularly among rural populations, those living in poverty, women and young people. Programmes to address the constraints to access to financial services among poor rural populations, such as the United Nations Capital Development Fund's (UNCDF) MicroLead programme (box 5.1), can make an important contribution to addressing this issue.

Lack of access to credit can be a major challenge, particularly for microenterprises, small and medium-sized enterprises (SMEs) and smallholder farms, an overwhelming majority of which are credit rationed (UNCTAD, 2014a, 2015b). Policymakers can consider using credit allocation to provide support to credit and savings cooperatives. Microfinance is potentially useful to support microenterprise, but unlikely to be sufficient.

In many LDCs (such as Bangladesh, Senegal, the United Republic of Tanzania and Uganda), information and communications technologies (ICTs) are opening up new opportunities for domestic resource mobilization beyond the traditional banking sector, notably through mobile banking and money transfer services (UNCTAD, 2012b: chap. 3). Such mechanisms have considerable potential, particularly where the outreach of formal banks is inadequate, and in a context

Finance plays a fundamental role in productive-capacity development.

Development banks can have a transformational impact.

Despite accelerated progress and new opportunities opened by ICT penetration, financial inclusion remains very limited in most LDCs.

Box 5.1. UNCDF's MicroLead and MicroLead Expansion programmes

UNCDF's MicroLead and MicroLead Expansion programmes have been in operation since 2009, with support from private philanthropic sources. Through these programmes, UNCDF is seeking to extend the frontier of finance into unbanked communities by investing in delivery innovations, including a variety of digital channels, agent networks and community-based savings groups. While these programmes are not exclusively dedicated to LDCs, 18 of the 21 countries in which they are active are LDCs (Benin, Bhutan, Burkina Faso, Burundi, the Democratic Republic of the Congo, Ethiopia, the Lao People's Democratic Republic, Liberia, Malawi, Myanmar, Rwanda, Sierra Leone, Solomon Islands, South Sudan, Timor-Leste, Uganda, the United Republic of Tanzania and Vanuatu), while one (Samoa) is a graduate from the LDC category.

The MicroLead and MicroLead Expansion programmes focus on providing safe, secure deposit accounts to unbanked and under-banked populations. Through the MicroLead Expansion programme, UNCDF is challenging formal financial service providers to reach rural unbanked populations, particularly women, with deposit products and financial education, both tailored to these unbanked populations' needs. By deploying alternative delivery channels, such as agency banking and digital financial services, and working predominantly through informal groups, the programme has increased understanding amongst financial institutions and their capacity to serve those who were previously considered unbankable. Its savings-led financial inclusion strategy has the potential to make a significant contribution in countries where exclusion is widespread and financial depth is limited. As of June 2016, MicroLead Expansion had reached more than 650,000 active clients with savings accounts and other services through the use of technology, alternative delivery channels, and informal savings group linkage models. 80 per cent of these active accounts were located in LDCs. By the end of the programme (scheduled for June 2017), it is expected to reach more than 1.3 million active customers in 11 countries, while moving further into rural markets with demand-driven, responsibly priced products.

Women are an important beneficiary group of the MicroLead Expansion programme, representing more than 70 per cent of its active clients. A meta-analysis of evidence from randomized control trials shows consistently positive economic outcomes as a result of increased access to savings, particularly for rural women, including increasing their productivity, profits and investment, as well as reducing asset sales to address health emergencies, improving consumption smoothing in the face of economic shocks, and increasing their legal and psychological control over funds (Buvinic and Furst-Nichols, 2014). Digital financial services also support women's participation in the labour force and increase their financial autonomy (GPFI, 2015).

Source: UNCDF.

of substantial rural–urban migration. Innovative approaches may be helpful in tailoring such financial services to the particular needs of potential customers, although the need for an adequate regulatory framework to ensure the reliability and integrity of the system should not be overlooked.

Macroeconomic policy frameworks should combine stability with investment dynamism and employment generation.

Investment needs are increased by the SDGs and the need for climate change adaptation.

5. MACROECONOMIC POLICIES

A development-oriented macroeconomic policy framework should combine macroeconomic stability with investment dynamism and employment generation. While sound macroeconomic fundamentals are part of an enabling environment for development, they are not sufficient to spur structural transformation. Graduation with momentum in most cases requires a considerable scaling up of investment to address the infrastructural and technological gaps that undermine both productivity and competitiveness and leave many LDCs exposed to structural vulnerabilities (as seen in chapter 1). The long-standing investment needs of LDCs are now magnified by two additional demands: first, to fulfil the social objectives of the Sustainable Development Goals, which will require considerable investment, especially in rural areas (UNCTAD, 2015b); and second, to meet the increased need for resilient infrastructure as a result of climate change. While recent trends indicate that LDCs have achieved an overall ratio of investment to gross domestic product (GDP) above the 25 per cent level deemed necessary for sustained economic growth (Introduction to this Report), maintaining this progress in the face of a slowing global economy remains a key challenge.

Fiscal policy has a key role to play in this context, both in financing public investment directly and through its potential to crowd in private investment in productive sectors. Particularly beneficial in the latter regard are strategic infrastructure projects to address bottlenecks that constrain the productive

sector. Public investments in road networks and electricity provision in African countries such as Ethiopia, for example, demonstrate the potential for such projects to enhance firms' competitiveness and unlock supply responses (Oseni and Pollitt, 2013; UNCTAD, 2015b). By using labour-intensive construction techniques where appropriate, infrastructure projects can also generate substantial multiplier effects, thereby contributing significantly to employment generation and inclusive growth (UNCTAD, 2013a: chaps. 4, 5).

However, in most LDCs, an increase in public investment on the necessary scale would require broadening the available fiscal space. As well as considerable improvements in taxation and revenue collection systems, this requires reforms to broaden the tax base and diversify public revenues sources; elimination of exemptions and regulatory loopholes; reinforcement of property taxation (especially in urban areas); and reducing tax evasion (UNCTAD, 2009a, 2014a: chap. 6). For those LDCs with abundant natural-resource endowments, it is also important to capture a greater share of resource rents. In particular, this requires avoiding a "race to the bottom" to attract resource-seeking investors and strengthening regulatory frameworks to prevent illicit financial flows related to trade mis-invoicing (UNCTAD, 2014b: chap. VII). Botswana may be regarded a success story in this respect, in that its State has successfully captured a major share of mining rents, which it has devoted to funding economic diversification (chapter 1).

Accelerated progress in this direction is critical to graduation with momentum, to reduce aid dependency and prepare graduating countries to cope with post-graduation changes in their development finance landscape.

The effect of a proactive fiscal stance could be enhanced by the adoption of accommodative monetary policies, shifting away from a narrow focus on price stability, especially while inflationary pressures are continue to be dampened by low international commodity prices. Monetary policy should take full account of the implications of national circumstances, notably policy regimes and financial development, for transmission mechanisms (UNCTAD, 2009b: chap. 2; Berg et al., 2013). Given the limited availability of credit to the private sector, due attention should also be given to the impact of monetary policy decisions on credit aggregates, and not only on interest rates.

Although a competitive exchange rate can be an instrument for the maintenance of export competitiveness, its use for this purpose is constrained in most LDCs by a combination of import sensitivity, structural current account deficits and external debt (chapter 1). Exchange rate stability may be enhanced through the appropriate use of capital controls and/or taxes on inflows of equity and portfolio investment, both to reduce the volatility of private capital flows and to increase their contribution to the achievement of overall development objectives. Ethiopia, for example, has traditionally limited its international financial vulnerability by limiting its opening to capital inflows mainly to FDI and government borrowing on international bond markets, while also making use of outflow controls (Alemu, 2016). Angola, the Democratic Republic of the Congo and Mozambique, among others, have implemented stronger controls on capital inflows than the sub-Saharan African average, while Burkina Faso, Guinea-Bissau and Senegal have put in place stronger-than-average controls on capital outflows (Massa, 2016).

Strategic infrastructure investments can crowd in private investment by easing supply constraints...

...but increasing investment requires broadening fiscal space.

A proactive fiscal stance can be more effective with accommodative monetary policies.

Exchange rate stability can be enhanced through capital controls.

6. EMPLOYMENT GENERATION

Graduation with momentum requires LDCs to generate jobs on a substantially larger scale than in the recent past, to provide productive employment for the growing cohorts of young entrants to the labour market, and thus to reap

the demographic dividend (UNCTAD, 2013a). The need for poverty-oriented structural transformation in LDCs to achieve the Sustainable Development Goals also requires employment creation to be combined with increased labour productivity (UNCTAD, 2014a). “[F]ull and productive employment and decent work for all” is not only explicitly included in the Sustainable Development Goals (Goal 8), but is also closely related to Goals 1 (poverty eradication) and 10 (reduced inequalities).

Employment creation is as imperative as productivity increases...

This combination of employment creation and increased labour productivity can be promoted by a three-pronged strategy:

- A transformative rural development agenda, synchronizing increased agricultural productivity with the complementary development of rural non-farm activities;
- Support to the development of microenterprises and SMEs, including by improving their access to capital and technical assistance on managerial and technology issues, and facilitating formalization;
- Public-sector-led employment creation, notably through the use of labour-based construction methods in large-scale infrastructure projects where appropriate.³

Complementary measures are also needed in education, including improvement of vocational training and reform of school curricula to increase their relevance to the needs of the labour market and the economy as a whole.

...requiring rural transformation, enterprise development and public-sector-led employment creation.

7. GENDER

The structural transformation and development of productive capacities required for graduation with momentum will inevitably be limited to the extent that certain population groups are constrained in their ability to engage in economic activities. A particularly important dimension of this broader issue of inclusivity is gender, as women constitute half of the human resource base and are systematically disadvantaged in most LDCs (chapter 1). Women’s engagement in economic activities is constrained by a wide range of obstacles to their access to labour and other markets, and to education, which interact with other market imperfections to diminish their productivity and entrepreneurial potential. Only if these constraints are addressed can the supply response to incentives aimed at increasing production be fully effective. Key issues are equal access for women to education, employment and other economic opportunities, finance and factors of production.

Structural transformation and productive-capacity development are limited by gender inequality and economic exclusion.

Thus, policies cannot be fully effective in promoting development and contributing to graduation with momentum unless women are empowered to realize their potential economic contribution to a much greater extent than is generally the case in LDCs at present. Consequently, reducing gender inequality needs to be a cross-cutting consideration across all policy areas, including (but not limited to) those discussed above.

Appropriate strategies in this area are particularly dependent on local circumstances, given the role of locally-specific cultures and traditions in many discriminatory practices. In general, however, tackling gender inequality requires a combination of policies, which are important both before and after graduation. These include:

- Actions to remove de facto discrimination in existing public policies and institutional frameworks (for example, educational systems, agricultural extension services, procedures for formalization of enterprises and land titling);

- Efforts to ensure that new policies and interventions do not lead to such discrimination, and where appropriate are skewed towards women in such a way as to counter the disadvantages that they face (for example, in public employment, support to smallholder farmers and microenterprises and small enterprises, and support to producer groups and cooperatives);
- Implementation of policies and other interventions to counter market mechanisms that lead to gender-differentiated outcomes (for example, in employment markets and access to finance);
- Proactive efforts to identify and harness new opportunities to counter the obstacles and disadvantages faced by women (for example, the spread of access to the Internet and mobile telephone networks, and the emergence of related financial services).

D. The international environment

As discussed in chapter 2, LDCs' economic performance is extremely vulnerable to changes in the international environment. Their exposure to exogenous shocks originating from the fluctuations of international markets is accentuated by geographical challenges, high levels of export concentration and commodity dependence, structural dependence on foreign savings and high (though declining) aid dependence.

While the economic environment for LDCs was relatively favourable in the years after 2000, reflecting global economic conditions (UNCTAD, 2010: chap. 1), it has been considerably less conducive to their development since the global financial and economic crisis. Following some encouraging signs of resilience in the immediate aftermath of the crisis, the uneven global recovery and slow world demand growth have since impacted on LDCs' economic performance (as discussed in the Introduction). Moreover, the external environment may well deteriorate further, if the effects of anaemic global demand and weak commodity prices are compounded by increased financial volatility. UNCTAD has already highlighted the dangers of mounting external and internal debt in a number of African LDCs (UNCTAD, 2016b). Further downside risks may stem from growing exchange rate volatility, most notably of the euro, whose effects are directly transmitted to those African LDCs in the CFA franc zone.

There is little doubt that a more stable and development-oriented international environment would contribute greatly to improving the economic outlook for LDCs. Such an environment should include, in particular, the resolution of two issues long highlighted by UNCTAD: volatility in commodity markets and the absence of a multilateral debt structuring mechanism (UNCTAD, 2010, 2015d). Less volatile and more predictable commodity markets would reduce the uncertainty of LDC export revenues and current account balances, as well as facilitating the mobilization of resource rents for the development of productive capacities (UNCTAD, 2008: chap. II; Nissanke, 2011).

Capital-scarce LDCs would also gain considerably from reform of the international financial architecture to redress its chronic instability, tackle the current crisis and address their particular vulnerabilities and concerns (UNCTAD, 2015d). Of particular importance to these countries is more stable and predictable provision of international liquidity, to enhance their access to development finance and allow them to address their distinctive needs (UNCTAD, 2014a). While official finance is only one of the pillars of resource mobilization, the recent decline in ODA disbursements to LDCs is a source of concern, especially in the context of the Sustainable Development Goals. Similarly, while the external debts of many LDCs were reduced through the Heavily Indebted

The global economic environment for LDCs has become more challenging since 2008, and may deteriorate further.

Reducing commodity price volatility and reforming the international financial architecture would greatly contribute to improving the economic outlook for LDCs...

...including by establishing a multilateral debt restructuring mechanism.

Poor Countries Initiative and the Multilateral Debt Relief Initiative, recent trends indicate that they would benefit considerably from the establishment of a multilateral debt restructuring mechanism, as well as from the ongoing reform of the debt sustainability framework. In order to contribute to international policy action, UNCTAD has formulated a coherent set of principles for sovereign debt resolution mechanisms (UNCTAD, 2015d: chap. V).

Strengthening regional integration and forging stronger financial and trading partnerships within the global South can also contribute to a more supportive international environment, both for LDCs and for graduates from the LDC category. Exports to regional and other Southern markets tend to be more sophisticated than those to developed country markets, providing greater scope for growth and structural transformation (Klinger, 2009; UNCTAD, 2010; UNECA, 2015a). Deepening regional integration could be particularly beneficial to LDCs in Africa, where negotiations for the establishment of a Continental Free Trade Area are underway and member countries of the Common Market for Eastern and Southern Africa, the East African Community and the Southern African Development Community have already reached an initial agreement on the establishment of a tripartite free-trade area (Mevel and Karingi, 2013; UNECA, 2015a).

Stronger regional integration and South-South cooperation can contribute to graduation with momentum in the financial sphere as well as in trade.

Likewise, closer regional cooperation in the financial sphere could contribute significantly to resource mobilization for the development of productive capacities. Potentially beneficial initiatives include measures to strengthen the role of regional development banks; foster the emergence of regional bond markets; reduce transaction costs for migrant remittances; and establish currency swap arrangements to reduce the need for reserve accumulation (UNCTAD, 2010, 2015d). Most African LDCs are involved in some form of initiative aimed at monetary and financial integration, in the context of regional trade agreements. These initiatives are currently at different stages of advancement, ranging from existing monetary unions (for example, the West African and Central African CFA zones, and the Common Monetary Area of the Southern African Customs Union) and planned monetary unions (for example, the West African Monetary Zone) to schemes for cooperation and convergence on monetary and financial issues (for example, in the Common Market for Eastern and Southern Africa and the East African Community) (UNECA, 2008).

Graduation with momentum requires concrete ISMs providing support commensurate with LDCs' development needs.

E. International support measures

As the discussion in chapter 3 of this Report highlights, there is unquestionably considerable scope to enhance the effectiveness of ISMs for LDCs. Sustainable development and graduation with momentum require the international community to move beyond symbolic acts, such as “best-endeavours” clauses and aid targets that remain unfulfilled for decades, to the establishment of specific and concrete measures providing tangible and predictable support that is appropriate to and commensurate with LDCs' development needs. There is thus a need for continued pressure on the international community to deliver such ISMs, as well as to fulfil their existing commitments and remove obstacles to LDCs' utilization of existing ISMs.

1. DEVELOPMENT FINANCE

The current development finance architecture is conducive neither to graduation with momentum nor to the achievement of the Sustainable Development Goals in the LDCs. ODA plays a critical role as the main source of external financing to LDCs, amounting to an average of \$47 per person and

some 5 per cent of gross national income in 2014. Achieving the Goals and the objectives of the IPoA will require a major increase in ODA to LDCs, to meet the international target of 0.15–0.2 per cent of donor country gross national income. All donors should also fulfil their commitment (under paragraph 52 of the Addis Ababa Action Agenda) to allocate at least 50 per cent of their net ODA to LDCs. This is of particular importance to those countries expected to make up the LDC group in 2025 and beyond.

Development partners should take account of the structural handicaps and vulnerabilities that characterize LDCs, and make aid more stable, more predictable and less procyclical (Guillaumont, 2015). The General Assembly (in resolution 67/221 (United Nations, 2013)) has also called upon development partners to consider the LDC criteria explicitly in their ODA allocations. In practice, however, donors have proved reluctant to link their aid in a consistent way to recipient countries' needs or levels of development (Alonso, 2015).

Graduation with momentum (and fulfilment of the Sustainable Development Goal and IPoA targets) also require improvements in development financing practices, to increase the effectiveness of ODA in promoting structural transformation and building resilience. A key aspect of this is closer alignment of ODA with recipients' national development strategies, in accordance with donor commitments under the Paris Declaration on Aid Effectiveness (OECD, 2005). As discussed in chapters 2 and 3, a key lesson of the graduation experiences of Botswana and Samoa was the importance of harnessing development finance to national goals.

Another important consideration is the sectoral allocation of ODA. Prior to the 2030 Agenda, influenced by the orientation of the Millennium Development Goals towards social goals, donors shifted ODA allocations towards social infrastructure and services, which accounted for 47 per cent of their total aid in 2014, compared with 30 per cent for productive-capacity-building, of which only one fifth was for agriculture. While ODA to social infrastructure and services is undoubtedly important, productive capacities require at least equal prominence, given the critical importance to all LDCs of removing constraints to productive investment, innovation and upgrading.

FDI flows to LDCs have increased over time, and now account for 3.5 per cent of their GDP. However, LDCs' capacity to attract private capital flows continues to be weakened by their structural conditions, including small domestic markets, limited financial sector development, weak regulation, limited human capital and inadequate infrastructure. Many LDCs have responded by seeking to attract FDI by offering foreign companies privileges and exemptions that are often not provided to domestic firms. However, as argued in *The Least Developed Countries Report 2010*, "the excessive focus on promoting FDI and neglect of domestic investment [is] ... a biased and counterproductive approach", particularly in view the role of a vibrant domestic private sector in attracting sustained foreign capital flows (UNCTAD, 2010:167).

The more recent graduate countries (Cabo Verde, Maldives and Samoa) have succeeded in increasing FDI in the post-graduation period, mostly in the tertiary sector, average net inflows rising from 2.4 per cent of their GDP in 2000–2002 to 5.9 per cent in 2013–2015. However, such an increase cannot be relied upon in all graduating countries. It is also important to ensure that financing is oriented towards the specific needs of each LDC. Where there is the prospect of a post-graduation increase in FDI, governments should therefore introduce policies ahead of graduation to promote domestic investment in, and orient foreign investment towards, development-oriented activities rather than extractive industries.

Donors should fulfil their ODA target commitments, and make aid more stable and predictable, and aligned with national development strategies.

Productive-capacity development should be as high a priority for ODA as social infrastructure and services.

Policies to direct FDI towards development-oriented activities may usefully be adopted before graduation.

Graduation with momentum requires the use of all appropriate financing sources, including borrowing (where this is possible within the limits of debt sustainability) as well as ODA and FDI. Combining financing from different sources can contribute to the advancement of wider development objectives (such as SME development, risk reduction, environmental benefits and improved access to financing opportunities), in addition to the direct benefits of individual investment projects.

Blended finance can offer opportunities, but needs to be treated with caution.

Blended finance — combining ODA and/or philanthropic funds with other private development finance — has been argued to offer an opportunity to leverage public resources to mobilize additional private finance for infrastructure and other investments, while underwriting risks and providing technical assistance and market incentives (AFD and UNDP, 2016). While large-scale projects can attract FDI, blended finance can also mobilize private domestic financing (for example, from pension funds and commercial banks), particularly for local development projects.⁴ It also has the potential to leverage diaspora direct investment in projects with transformational impact (UNCTAD, 2012b).

However, while blended finance may thus have the potential to contribute to graduation with momentum, caution is warranted in its use, due to the complexity of the related financial instruments and the risk of creating contingent liabilities for the public sector. It is also important that the share and terms of the concessional element appropriately reflect the level of development and vulnerability of the recipient country. The use of blended finance should therefore be restricted to projects that would not be undertaken in the absence of such financing, and should prioritize projects with clear benefits for economic and social development (UNCTAD, 2015d: chap. VI).

Climate funds should conform to the principle of common but differentiated responsibilities.

Public participation in blended finance can also be used as an instrument of industrial policy, through use of the concessional element (typically funded by ODA) to orient investments towards activities with a potentially transformational impact (for example, in new sectors or in technological upgrading), or which promote inclusiveness (for example, through job creation, rural development, or economic empowerment of women or marginalized groups) or environmental sustainability. Blended finance projects may also contribute to institutional development, through technical assistance to local banks, pension funds, and national and local authorities for project financing, impact assessment and risk mitigation techniques, for example (UNDP and UNCDF, 2016).

Financial instruments such as GDP-indexed bonds, countercyclical loans and weather insurance may have some potential to reduce vulnerability and improve risk management — an issue of particular importance to the 40 LDCs that have relatively high economic vulnerability, as measured by the EVI. It may also be possible to build domestic resilience through appropriately designed insurance policies to offset the losses associated with underdeveloped infrastructure.

Technical assistance is needed to develop and secure adequate financing for green investment projects.

Despite their negligible historical contribution to climate change, it is LDCs that are most affected by its impacts. Various types of external financing, some of them LDC-specific, are available to help LDCs to strengthen their resilience to such impacts. Such funds should conform to the United Nations Framework Convention on Climate Change, in particular the principles of common but differentiated responsibility and respective capacities. Development partners should both increase technical assistance to LDCs to incorporate climate adaptation needs into their national development strategies, and ensure that the LDC Fund has adequate resources to finance these needs in full and in a timely manner.

Graduation from the LDC category must not prevent countries from accessing climate funds. Rather, graduating countries should retain access

commensurate with the needs and risks they face, in line with smooth transition practices. The Green Climate Fund, a stand-alone multilateral financing entity that aims to deliver equal amounts of funding for mitigation and adaptation, could be extremely beneficial to LDCs and graduating countries alike.

Technical assistance is also needed to enable LDCs and graduating countries to develop green investment projects and secure adequate financing for them, including through innovative financing mechanisms such as green and blue bonds, whose proceeds are tied to environmentally friendly investments. However, effective mobilization of all these financing mechanisms requires significant improvements in LDCs' managerial and institutional capacities.

2. PROPOSAL: AN LDC FINANCE FACILITATION MECHANISM

Chapter 3 highlighted the problems arising, not merely from the limited fulfilment of international commitments to financial ISMs, but also of the constraints LDCs face in securing access to those that are available. This applies both to LDC-specific ISMs and to those open to all developing countries, under which LDCs are in principle equally entitled to support.

A key issue is access to finance. Over recent decades, an increasingly complex architecture of international finance for development has evolved, encompassing an ever-growing multitude of separate but interrelated multilateral, regional, bilateral and public–private institutions and mechanisms, and separate funding windows within institutions. While the case of climate finance, highlighted in chapter 3, is particularly acute, the issues of fragmentation and complexity extend across the development finance architecture as a whole.

This has two consequences. First, while the 2030 Agenda emphasizes the holistic and interdependent nature of the various elements of sustainable development, funding is increasingly compartmentalized, potentially impeding financing for (and thus discouraging) investments based on cross-cutting or holistic approaches. Second, increasing fragmentation has given rise to multiple potential funding sources for projects within certain areas. This may be an obstacle to locating an appropriate funding source, as each agency has its own particular criteria and priorities, as well as its own (often complex) application and monitoring procedures. These two aspects give rise to an unnecessary obstacle to funding and an excessive burden on the institutional capacities of LDCs. There is also a risk that they will give rise to a corresponding fragmentation of investments in recipient countries at the expense of more systemic and holistic approaches, and that investment programmes will become driven by the priorities of funders rather than countries' own needs and priorities.

These issues argue for a considerable streamlining of the development finance architecture across all sectors; for much faster progress towards the coordination and harmonization of donor requirements; and for greater efforts to ensure that such requirements take full account of the constraints facing recipient countries, particularly LDCs. However, the limited progress made towards fulfilment of commitments in these areas in the decade since the Paris Declaration (OECD, 2005) indicate the need for an alternative approach if this is not to be a serious obstacle to the achievement of the Sustainable Development Goals.

Specifically, the effectiveness of financial ISMs could be greatly enhanced by the establishment of an LDC finance facilitation mechanism (FFM) as a “one-stop shop” to identify potential funding sources for the investment projects contained in their national development plans across all areas of sustainable development, and to support funding applications from LDCs. By developing the necessary

The architecture of international finance for development has become increasingly complex and fragmented...

...giving rise to an unnecessary obstacle to funding and an excessive burden on LDCs' institutional capacities.

A considerable streamlining is needed and a finance facilitation mechanism for LDCs could address the issues more immediately.

knowledge of donor requirements, priorities and preferences, and monitoring the constantly evolving architecture of development finance, this could provide a valuable public good to LDCs. It could greatly enhance the efficiency of the process by which the investment needs identified by each country are matched with funders' priorities; reduce funding delays and uncertainties; lessen the administrative burden on LDCs associated with securing investment financing; and support the movement towards greater country ownership and more country-led development strategies, as envisaged in the Paris Declaration and the 2030 Agenda.

Achieving 100 per cent DFQF coverage for LDC exports would be an important step.

Appropriately designed and implemented, such a mechanism could also contribute to national capacity development through secondments and "shadowing" of FFM staff on country missions, as well as through capacity-building and training programmes. It could also play an important role as an advocate, both for improved delivery on financial commitments to financial ISMs, and for improved donor coordination and harmonization.

Adequate funding would be essential to the effectiveness of such a mechanism. While costs could be limited by locating it within an existing institution, the demands of matching the investment needs of 48 countries with the priorities of many hundreds of potential funding sources would be considerable; and with inadequate funding or staffing it could potentially become a bottleneck, which would obstruct the process as much as facilitating it. However, in light of the key role of LDCs in the achievement of the Sustainable Development Goals, and of development (and climate) finance in the attainment of the Goals in these countries, this might be expected to be a high priority for donors. In view of its long-standing work on financing for development and on LDCs, UNCTAD could play a useful role as a member of the board of the FFM, which would decide its priorities, policies and practices.

A key objective of smooth transition should be to maintain some degree of preferential market access in key export markets.

3. TRADE⁵

Although not all countries have adopted preferential trade schemes for LDCs, and the coverage of existing duty-free quota-free (DFQF) arrangements remains incomplete, preferential market access stands out as one of the most effective ISMs in favour of LDCs. Achieving 100-per-cent DFQF coverage for all exports from all LDCs would thus represent an important step, both towards the Sustainable Development Goal target of doubling LDCs' share in global exports (target 17.11) (Bouët and Laborde, 2011; Nicita and Seiermann, 2016) and towards graduation with momentum. By the same token, the loss of preferential market access represents the most serious negative factor in the economic calculus of graduation, giving rise to potential annual losses of export revenues in excess of \$4.2 billion across LDCs as a whole. The implications vary greatly across countries according to their respective trading patterns, export compositions and alternative trade arrangements (chapter 4). In some Asian LDCs in particular, there is a risk that the competitiveness of manufactured exports may be undermined. In a context of footloose foreign investment, and given outsourcing practices in buyer-driven value chains (notably in the apparel sector), this could trigger some relocation along global production networks, jeopardizing these countries' diversification efforts.

Successful smooth transition requires a proactive role of the graduating country and collaboration of development partners.

Thus, a key feature of a successful smooth transition strategy is to ensure that some degree of preferential access is retained in key export markets through other unilateral preference schemes (such as the Generalized System of Preferences), or through bilateral or regional agreements. This requires both a proactive role on the part of the graduating country and collaboration and flexibility on the part of its developed and developing trade partners, to prevent the disruption of trade relations along established value chains. The experience

of Cabo Verde is paradigmatic in this regard: shortly after losing its eligibility under the European Union's LDC-specific Everything But Arms initiative, the country successfully applied to its Generalized System of Preferences Plus scheme, hence retaining a significant preference margin relative to its non-LDC competitors (chapter 4).

Notwithstanding the tangible benefits of preferential market access, however, it is important not to overemphasize its strategic value. Preference erosion can be expected to continue as liberalization of trade continues, and may well accelerate with the conclusion of "mega-regional" trade agreements currently under discussion; and this will inevitably reduce the commercial value of preferential treatment for LDCs over time (UNECA, 2015a). To offset the effects of preference erosion, preference-granting partners could review their respective rules of origin, to bring them into line with the WTO Ministerial Decision on Preferential Rules of Origin for Least Developed Countries, originally adopted in 2013 in non-binding language and further elaborated two years later.

The strategic value of preferential market access is further weakened by the growing relevance of trade-restrictive non-tariff measures (NTMs) relative to tariff barriers, which has been identified in a growing body of research (UNCTAD, 2013b).⁶ This is particularly pertinent in the context of LDCs, many of which are specialized in products (notably agricultural goods) that are subject to numerous NTMs, and whose producers face particular difficulty and/or expense in complying with them (Nicita and Seiermann, 2016).

This highlights the importance of strengthening technical and financial assistance to LDCs on NTM-related issues in the context of the Aid-for-Trade initiative. Key elements of such assistance include:

- Strong and tangible support for the upgrading of hard and soft infrastructure in LDCs;
- Capacity-building for the private sector, particularly SMEs, on NTM compliance and related challenges;
- Capacity development and institution-building in the areas of quality assurance and standard-setting and -monitoring;
- Assistance for systematic data collection and dissemination on NTMs and their restrictiveness;
- Technical assistance for the implementation of the Trade Facilitation Agreement, to reduce trade-related costs (notably for SMEs), and exploit the flexibilities in part II of the Agreement to ensure that the sequencing of implementation measures supports each country's development objectives.

Ongoing efforts to streamline NTMs should also be maintained, and should aim to ensure convergence, to the extent possible, towards commonly accepted international standards so as to reduce compliance costs (UNCTAD, 2013b).

Trade facilitation is of particular importance because of the alarming prevalence of trade mis-invoicing practices in LDCs, and their serious impact on domestic resource mobilization. The considerable scale of illicit financial flows, in particular from African LDCs, highlights the need to strengthen the international cooperation framework between customs agencies, revenue authorities and other related agencies to tackle such practices (UNCTAD, 2016c; UNECA, 2015b). Realizing the potential to leverage the customs cooperation provisions of the Trade Facilitation Agreement to curb trade misinvoicing is thus a priority for LDCs, as well as strategic use of the flexibilities enshrined in part II of the Agreement to reduce administrative obstacles to trade and reduce the high trade-related costs faced by LDC producers.

The strategic importance of preferential access should not be overemphasized given preference erosion and the growing relevance of NTMs.

Technical and financial assistance to LDCs on NTM-related issues should be strengthened.

Trade facilitation reforms and customs cooperation should be leveraged to curb trade misinvoicing.

Further progress is also needed towards operationalizing the so-called LDC services waiver, to enable LDCs to take greater advantage of the expansion of international trade in services (UNCTAD, 2015e). A number of LDCs, particularly small island developing states, could benefit significantly from increases in the number of preference-granting countries and of the commercial value of preferences under the waiver. This could contribute to reducing the chronic commodity dependence of many LDCs (although services trade can also be volatile). As technological change and the emergence of GVCs have blurred the distinction between goods and services, there may be particular merit in boosting high-value-added services that have strong complementarities with manufacturing, notably in areas such as finance and ICTs.

Further progress is needed towards operationalizing the LDC services waiver.

More generally, it is clear that LDCs stand to benefit from a reinforcement of the regime of special and differential treatment (SDT) granted to them in the WTO context, and efforts are needed to break the current stalemate on this issue. The Monitoring Mechanism adopted at the Ninth WTO Ministerial Conference could offer a useful means for LDCs (as well as ODCs) to advocate for a strengthening of SDT provisions. Efforts are also required to preserve the existing flexibilities to the extent possible. LDCs should carefully consider the strategic advantages and disadvantages of proposed “WTO-plus” arrangements in regional and bilateral trade arrangements, especially those among countries at largely different levels of development.

An emerging concern is the current lack of a systematic set of smooth transition procedures within the WTO legal framework to ensure that eligibility for SDT provisions is not lost abruptly on graduation. In the absence of such provisions, graduation requires simultaneous modifications to existing legislation across several areas to implement multiple WTO obligations from which LDCs, but not ODCs, are exempt. This demands considerable time and resources, and can give rise to significant uncertainty and disruption for producers and investors. Technical assistance to preparations for this transition phase may also be helpful, particularly to those graduating countries with limited institutional capacities.

The absence of a systematic set of smooth transition procedures in the WTO is an emerging concern.

4. TECHNOLOGY

Technology has, to a great extent, been the missing link of the ISM architecture for LDCs. Despite the key role of technological upgrading in structural transformation and the development of productive capacities, ISMs in this field have hitherto been very limited.

In principle, the establishment of the United Nations Technology Bank, with the stated objective of contributing to LDCs’ efforts to build a solid and viable technological base, represents a first step towards filling this gap. However, its effective fulfilment of this role will depend, inter alia, on:

Technology has been the missing link of the ISM architecture.

- Implementation proceeding on the current schedule without further delay, particularly in light of the considerable lapse of time since the initial proposal of the Bank (2011);
- Establishment of a continuous monitoring mechanism to ensure that the Bank’s stated objective is fulfilled;
- Adequate financing, especially as activities are expanded, to ensure that the Bank’s effectiveness is not impaired by insufficient funding, as many other ISMs have been;

- Due consideration of the development level of each LDC in the provision of technical assistance to intellectual property management. Different levels of economic development require different systems of intellectual property, as they typically become more stringent at higher levels of development (Hoekman et al., 2005; Gehl Sampath and Roffe, 2014). Therefore it is important to avoid encouraging LDCs to adopt more strict intellectual property protection systems than are compatible with their development level.

The Bank could play a particular role in the transfer of technologies not subject to intellectual property (for example, those generated by collaborative processes for incremental innovations based on free access such as open-source innovation) and those that are at the end of intellectual validity, which are often as relevant to LDC development as those subject to continuing intellectual property protection.

The establishment of the Technology Bank by no means obviates the need to implement other ISMs in the field of technology. In particular, the ISM foreseen in article 66.2 of the TRIPS Agreement could be advanced through implementation by the TRIPS Council of its own 2003 decision to review the system for monitoring developed countries' compliance with their obligations under this article. The Council could usefully require developed countries to adopt a standard format for reporting to provide comparable information on programmes and policies, on the basis of an agreed definition of technology transfer. Such reports could also provide information on the financing involved and, critically, on the impacts of the measures taken. LDCs could move beyond their current focus on TRIPS-Agreement implementation to report on the contribution of such technology transfer to the establishment of a sound and viable technological base, and/or submit needs assessments indicating priority areas and sectors for technology transfer (Foray, 2009; Moon, 2011). This would provide greater clarity to the processes and programmes by which developed countries provide incentives for the transfer of technologies that contribute to the building of technological capabilities in LDCs and thus to their long-term sustainable development.

Technology-transfer activities by developed countries could usefully focus on technologies whose transfer is unprofitable to technology owners, due to high costs associated with a limited absorptive capacity in the receiving country, but has a high social return because the technologies correspond to local needs and contribute to technological upgrading and/or social development. In these circumstances, market incentives are insufficient to bring about technology transfer, and additional incentives are therefore required. Such technologies might include, for example, those needed for the production of drugs and vaccines for tropical diseases. A second area of focus is medium-level technologies oriented towards entrepreneurs serving local markets, which may better reflect the factor endowments characteristic of LDCs than more advanced and capital-intensive technologies, and be more readily absorbed (UNCTAD, 2014c; Foray, 2009).

Developed countries could also contribute to improving the effectiveness of technology transfer by funding agencies specialized in linking donor agencies, private firms holding particular technologies and entrepreneurs in LDCs, acting as "one-stop" brokerage services for buying and selling intellectual property. Such agencies would identify the technology needs of firms in LDCs, locate potential providers of these technologies, and act as intermediaries in the technology-transfer process, while addressing intellectual-property-related issues and acting to ensure the effectiveness of technology transfer in the recipient country (Foray, 2009).

The Technology Bank, once in operation, could be a first step towards filling the gap...

...but does not obviate the need for other technology-related ISMs, such as operationalizing article 66.2 of the TRIPS Agreement.

Technology transfer could focus on technologies whose transfer is unprofitable, despite high social returns.

Aid could support "one-stop" brokerage services for intellectual property.

F. Least developed country criteria

The political declaration of the Comprehensive High-level Midterm Review of the Implementation of the IPoA (United Nations, 2016a: para. 48) states that:

We recognize the importance of the reviews by the Committee for Development Policy of the graduation criteria for the least developed countries. We recommend the reviews be comprehensive, taking into account all aspects of the evolving international development context, including relevant agendas.

The 2030 Agenda suggests a possible need for revision of the graduation criteria.

Given its broader scope compared to previous development frameworks, the 2030 Agenda would seem to suggest a possible need for revision of the criteria, particularly in light of the growing economic divergence between LDCs and ODCs (chapter 1). There is also a case for considering modifications to the criteria to take greater account of the considerable heterogeneity of the LDC group, not least with respect to their geographical vulnerabilities.

In the context of graduation with momentum, there may also be some potential to improve the ability of the graduation criteria to capture the extent to which LDCs have overcome the structural impediments to their development. The experiences of the countries that have already graduated or are expected to graduate in the coming years (chapter 2) highlight two particular issues: the potential for LDCs to graduate without having achieved substantial structural transformation; and the failure of any LDC graduate to date to achieve the graduation threshold for the EVI.

The role of structural transformation in the criteria could be improved and strengthened.

In addition to increasing the alignment of the LDC criteria with the 2030 Agenda and the Sustainable Development Goals, consideration could be given to incorporating the perspective of graduation with momentum, to embed graduation in a longer-term process of sustainable development. This could be done by improving the measurement of structural transformation in the criteria and increasing its weight. The share of agriculture, fisheries and forestry in GDP, used as a proxy for structural transformation within the EVI (see box figure 1.1 in chapter 1), is at best a partial and imperfect indicator in this context. On the one hand, agricultural upgrading increases the indicator (other things being equal) because it expands agricultural production, which goes against improvements in the EVI; but agricultural upgrading is a critical component of what *The Least Developed Countries Report 2015* calls “poverty-oriented structural transformation” in LDCs (UNCTAD, 2015a), a precondition of graduation with momentum. On the other hand, the expansion of low-value services in the informal sector reduces the agriculture indicator, but this type of growth of the services sector does not contribute to structural transformation. These considerations show the shortcomings of the component of the EVI under analysis. The component might therefore be replaced with a composite index more fully reflecting the extent of structural transformation, encompassing the structure and diversification of production, employment and trade; technological capabilities; labour productivity; urbanization; and demographic dynamics. It would also be possible to increase the weight of structural transformation in the EVI, by according a far greater weight to this composite indicator than that accorded to the agriculture index in the current criterion. One approach would be to off-set this by reducing the weights of geographical variables (size and remoteness), which are essentially static rather than dynamic, and thus change little over time.

The environmental aspect of the EVI could also be improved to reflect a broader range of issues.

Consideration could also be given to improving the environmental aspect of the EVI. The environmental subindex is currently limited to the share of

population in low-elevated coastal zones and victims of natural disasters (see box figure 1.1 in chapter 1). However, while the former is clearly of critical importance to some LDCs (notably Bangladesh, Kiribati and Tuvalu), it is not an effective indicator across all LDCs, particularly those that are landlocked, where it is zero. It might therefore be beneficial to extend the environmental subindex. Possible approaches would include adding components reflecting environmental issues of particular relevance to LDCs, such as the frequency of extreme weather events and/or the volatility of precipitation; or using existing environmental indices.⁷

Given the importance of gender inequality as an obstacle to structural transformation and development, there might also be a case for adding a gender component to the graduation criteria. A relatively straightforward approach would be to add a gender component to the HAI.⁸

Beyond possible modifications to the formulae used for the criteria, consideration could also be given to establishing a “vulnerability ceiling” — that is, a maximum level of the EVI that all countries would need to meet in order to graduate, in addition to satisfying the existing criteria.⁹ It could be set at half the level of the graduation threshold. Given the key importance of reducing structural vulnerabilities to reach sustainable development beyond graduation, this might be seen as representing a maximum level of structural vulnerabilities compatible with graduation with momentum.

A more far-reaching proposal, in line with the concept of graduation with momentum, would be to separate the structural transformation and environmental dimensions and build separate indices. The structural transformation index could also be made a mandatory condition for graduation.

A gender component could be added to the HAI.

A "vulnerability ceiling" could be considered as a condition for graduation.

G. Summary

- There is a need to move from graduation strategies focused on meeting the statistical criteria for graduation to “graduation-plus” strategies that take a longer-term perspective and lay the foundations for subsequent development by building productive capacities and fostering structural transformation.
- Accelerated transformation of rural economies is essential, through coordinated measures to upgrade agriculture and promote non-farm activities, taking full advantage of the synergies between the two.
- Structural transformation requires proactive policy action encompassing a combination of cross-sectoral and sector-specific industrial policies.
- A considerable scaling up of public investment is required, especially in rural areas, including projects that strategically address bottlenecks in the productive sector. This requires increasing the available fiscal space by improving taxation and revenue collection systems, diversifying public revenue sources and addressing the challenge of illicit financial flows, which besets fuel- and mineral-exporting countries in particular.
- Addressing gender inequality as a cross-cutting issue across all policy areas is essential, to ensure that human resources are used more fully and more efficiently, and entrepreneurship and creativity are harnessed more effectively for development.
- A more stable and development-oriented international environment is conducive to graduation with momentum, as well as better and more effective ISMs. Key issues are reforms to reduce volatility in financial and commodity markets and to resolve debt crises effectively.

- Donors should meet their long-standing commitments both on the level of ODA to LDCs and on aid effectiveness, including by making aid more stable and predictable and aligning it with national development strategies to support the development of productive capacities.
- An LDC finance facilitation mechanism could increase and accelerate LDCs' access to official finance and reduce the burden on their limited institutional capacities—but adequate funding and staffing would be essential. UNCTAD could play a useful role as a member of its board.
- Fulfilment of the commitment to 100-per-cent DFQF market access for all exports from all LDCs would represent an important step; and trading partners should bring their rules of origin into line with the 2015 WTO Ministerial Decision on the issue.
- Efforts are needed to break the current stalemate on reinforcing the existing SDT regime in the WTO, since that would ensure that SDT measures become more meaningful and effective.
- Technology has been the missing link of the ISM architecture. Once operational, the Technology Bank should help to fill this gap; but other measures are also needed to promote technology transfer to LDCs and the strengthening of their technological capabilities.
- Consideration could be given to revising the graduation criteria to give greater weight to structural transformation; to improve their environmental dimension; to take account of gender inequality; and/or to impose a ceiling on the level of vulnerability at graduation.

Notes

- 1 The political declaration of the Comprehensive High-level Midterm Review of the Implementation of the IPoA states: “It is also important that graduation be seen not as a cut-off point, but as a resolute move towards better and sustained economic development and virtuous and inclusive sustainable development.” (United Nations, 2016a: para. 46).
- 2 Various tools have been developed which could be used in this context, including growth diagnostics (Hausmann et al., 2008), industrial strategy design (UNCTAD and UNIDO, 2011), operationalizing the product space (Fortunato et al., 2015) and the Growth Identification and Facilitation Framework (Lin and Monga, 2010).
- 3 “Labour-based in relation to the production process and technologies used in the production of goods and materials and in Construction Works means methods of production and technologies that are designed and managed so as to promote the creation of employment with predetermined socio-economic benefits” (ILO, 2002: Glossary of terms).
- 4 In the case of the Local Finance Initiative of UNCDF (which finances transformative investment with impact on local communities) for example, the leverage ratio between the ODA (grant) element and domestic finance is 1 to 10 (UNDP and UNCDF, 2016).
- 5 The rise of global production networks has dramatically intensified the interconnection between international trade and investment flows. Thus, while the following discussion essentially takes an international trade perspective, reflecting the more tangible nature of ISMs in this area, much of it also pertains, *mutatis mutandis*, to international investment.
- 6 Despite the overall weakening of tariffs as trade barriers, their role is uneven across products and industries. Thus, tariff escalation in metal products still can act as a deterrent to export upgrading in LDCs, as seen in chapter 3.
- 7 Examples of environmental indices are the Environmental Performance Index (Hsu, 2016) and the Physical Vulnerability to Climate Change Index (Guillaumont and Simonet, 2011).
- 8 An indicator of the gender gap which can be used is the Gender Development Index calculated by the United Nations Development Programme as part of the Human Development Index.
- 9 It is important to recall that improvements in the vulnerability situation of a country are reflected in reductions of the EVI. This is the opposite of the other two LDC criteria (Income and HAI), where improvements are measured as increases in the indicators.

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