Devising approaches to stimulating economic diversification and promoting value added production, including through investment, with a view to providing equal economic opportunity for all, particularly women and youth

Note by the UNCTAD secretariat

Executive summary

Sectoral transformation and diversification, capital accumulation and social inclusiveness are all key drivers of development. These processes do not spontaneously result from market forces alone, but require the action of social and economic actors, including developmental States. This background note presents the changing sectoral composition of value added and employment in the past four decades, showing progress and setbacks, reviews recent trends in industrial policies, and discusses some key challenges in the formulation and implementation of policies aimed at sustainable and inclusive development.
Introduction

1. The third session of the Multi-year Expert Meeting on Enhancing the Enabling Economic Environment at All Levels in Support of Inclusive and Sustainable Development focuses on the crux of the post-2015 development challenge, examining the processes of structural change that can enlarge and diversify a country’s productive capacity, help shift resources towards higher productivity activities, encourage technological upgrading and enhance prospects for creating more decent jobs. Combined with the more quantitative drivers of development, such as high rates of capital formation and increased exports, achieving economic diversification is not only key to successfully integrating into the global economy but also necessary to bolster domestic demand in expanding sectors.

2. In its broadest terms, successful structural transformation is associated with a shift of population from rural to urban areas and a constant reallocation of labour within the urban economy to higher productivity activities. Agricultural employment declines as mechanization spreads into the primary sector, while mutually reinforcing links between output growth and productivity growth help the manufacturing sector absorb an expanding labour force, before industrial employment begins to decline at higher income levels. Complementarities between services and manufacturing ensure a steady rise in employment and output in transportation, energy, finance and the provision of public goods.

3. The specific details of this evolving pattern of economic transformation are influenced by geographical location, resource endowments, market size and institutional conditions, with some combinations being more conducive than others to structural transformation and raising income. Successful countries tend to have high savings rates, a high share of manufacturing output in gross domestic product (GDP) and a high profit share in manufacturing. These mutually supporting features point to the importance of a strong profit–investment nexus in establishing a sustainable development path.

4. Such a path is, however, unlikely to emerge in a closed economic environment. From the point of view of poorer countries, increased trade and access to external markets can open a vent for surplus, permitting the employment of underutilized labour and land to produce primary and labour-intensive goods for export, easing their balance-of-payments constraints and introducing dynamic gains through specialization and economies of scale. Although such gains from trade can be important, particularly in the early stages of development, UNCTAD, along with others, has stressed that trade is not a panacea. Complementary policies are needed to avoid locking countries into an established pattern of production that – even if it makes efficient use of a country’s resource endowments – may not generate the more dynamic productivity gains that drive catch-up growth. Such policies depend on a variety of macroeconomic, structural and technological factors that need to be in place for a strong investment–export nexus to emerge, and to support a more diversified economic structure.

5. The kind of investment–export nexus compatible with sustainable growth and development is unlikely to emerge automatically, even for commodity exporters and labour-intensive manufacturers, through which many developing countries have their greatest resource and cost advantages. When it comes to building more inclusive and sustainable development paths, it is not just the volume of trade that matters. Most countries appear to have diversified their output and trading profiles as they successfully move up the income ladder, before becoming less diversified as they shift to a more services-driven economy at high levels of development. Such diversification appears to be closely linked to improving employment conditions and bolstering economic resilience to external shocks.

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6. Historical experience shows that mutually supportive links between profits, investments and exports in support of sustainable growth and development do not result spontaneously from the free play of market forces. Moreover, policy challenges increase considerably as the production process becomes more knowledge intensive and intensive in scale, since the technological and organizational capabilities required to compete internationally are becoming more costly to acquire and more difficult to master, and the investment climate is becoming more challenging. Therefore, the role of social and economic actors, including the developmental State, needs to be carefully analysed to understand how best to combine and manage the processes of economic diversification and social inclusion. Doing so will be key to meeting the Sustainable Development Goals.

7. In the last decades, progress in such transformation processes has been partial and uneven, with remarkable achievements in some countries and regions, but also significant setbacks, including some countries falling behind and others enduring a damaging process of premature deindustrialization, while the informalization of work has been a frequently documented feature even in economies that have enjoyed strong growth spurts.2

8. The third session of the Multi-year Expert Meeting provides an opportunity to discuss the reasons for these different outcomes, and also to reconsider how development strategies have to be adapted to the present context. Chapter I of this note provides a rapid review of some of the broad trends in economic diversification among developing countries; chapter II discusses the renewed interest in industrial policies; and chapter III examines some challenges that lie ahead.

I. Trends in sectoral value added and employment

9. Recent history (1970–2013) and current trends in the sectoral distribution of value added in developing countries, countries with economies in transition and developed countries are shown in the table. Though the categories are at a high level of aggregation, some central trends may be noted in reviewing the figures. For example, one corresponds to the reduction over the long term of the share of agriculture in GDP. This was particularly pronounced in developing countries (from 25 per cent in 1970 to less than 10 per cent in 2013), followed by countries with economies in transition (from around 17 per cent in 1970 to less than 6 per cent in 2013) and by developed countries, where this shift had already largely taken place in previous decades. This trend corresponds with a well-known stylized fact in the process of development, whereby agriculture is first replaced by industry as the main economic activity, and industry thereafter substituted by services.

10. The relative weight of industrial sectors (mining, manufacturing, utilities and construction) has differed in developed countries, developing countries and countries with economies in transition. The share of these sectors in GDP has shown a steady decline in developed countries (from 36 per cent in 1970 to 23 per cent in 2013), which is still within the normal stylized facts for mature economies. Industry has also shown a very significant decline in countries with economies in transition, which took place between 1990 and 2000. In this instance, however, the reduction was caused by the collapse of a former development strategy; it was therefore more related to a premature deindustrialization (as the decline was entirely due to manufacturing) rather than to the natural outcome of industrialization reaching its maturity. Finally, developing countries have shown a mixed trend, with industrial sectors declining between 1980 and 2000 (as negative trends in Africa and Latin America outweighed positive trends in East Asia and South-East Asia) and

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recovering after 2000. Much of the differences across sectors were due to varying policies in different countries or different periods in the same country.

11. Services overall (the last three sectoral categories in the table) were the major source of value added in all three groups of countries in 2013, totalling 52.3 per cent, 58.2 per cent and 75.0 per cent in developing countries, countries with economies in transition and developed countries, respectively. Moreover, the share of this sector in GDP had increased the most. This is, however, a very heterogeneous sector, in which subsectors with very high and very low productivity coexist. It is therefore necessary to examine how the different components of this sector have evolved, to better assess the impact of services sector expansion on growth and development. Furthermore, it is necessary to analyse the interrelations of a number of modern services (such as transport, information and communications and finance and business services) with other economic activities, including agriculture, manufacturing and extractive industries. A number of dynamic emerging subsectors within the services sector could have the potential to generate growth, trade and employment opportunities. For instance, logistics and distribution could greatly benefit Africa’s agriculture (including agribusiness and food trade) and manufacturing sectors, while infrastructure services – encompassing transport, telecommunications, water, energy and financial services – are of critical importance to economic development. Reciprocally, the growth of such services relies on the development of other modern sectors. The overall impact of the services sector on the development process also depends on the employment it generates and its contribution to the expansion of domestic markets.

Table

### Sectoral distribution of value added by economic group, 1970–2013

(Percentage)

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Source: UNCTAD secretariat, based on national accounts data from the United Nations Statistics Division.

Note: “Other services” comprises International Standard Industrial Classification categories J to P.

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12. In considering employment trends rather than value added, deindustrialization may be observed more broadly across regions and more strongly after 1990. Moreover, deindustrialization appears to be setting in earlier for developing countries, that is occurring at a lower level of income than occurred in developed countries, and is particularly pronounced in the poorest countries. These trends are particularly noticeable in sub-Saharan Africa, which began to deindustrialize from very low earlier peaks. This sort of deindustrialization goes beyond being premature and has been described as pre-industrialization deindustrialization.4

13. Employment figures can also reveal other important features of the transformation process in developing economies. Figure 1 illustrates the composition of employment by gender in developed, developing and transition economies. Women’s employment is lower than men’s across all of these groups, particularly in developing economies, where more than 60 per cent of the employed population are men. The imbalance is particularly strong in North Africa, South Asia and West Asia, while it tends to diminish in Latin America and the Caribbean. By contrast, transition economies exhibit more balanced participation by gender in labour markets.

Figure 1
Composition of employment by economic group and gender

Source: UNCTAD secretariat, based on the International Labour Organization Key Indicators of the Labour Market database.

14. Youth employment-to-population ratios are generally lower than those for adults, and have been declining in many regions. In developing countries as a whole, between 2000 and 2013, youth employment participation declined from 49.0 to 46.7 per cent for women and from 76.3 to 74.5 per cent for men.

15. Figure 2 illustrates the sectoral distribution of employment by region and gender for 1998 and 2008. The services sector is by far the largest source of both women’s and men’s employment in developed economies and transition economies (that is, Central and South-Eastern Europe) and in Latin America and the Caribbean, although women have a higher and increasing share of employment in the services sector relative to men in all three regions. Employment in agriculture predominates in South-East Asia, South Asia and sub-Saharan Africa for both women and men; much of this employment corresponds to

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4 F Tregenna, 2015, Deindustrialization, structural change and sustainable economic growth, United Nations University Background Paper No. 2015-032.
self-employed or contributing family workers. Industry is a more significant source of employment for men than women throughout the world, though the industrial share is similar for women and men in East Asia and South-East Asia.

Figure 2

Sectoral distribution of employment by region and gender, 1998 and 2008

Source: UNCTAD secretariat, based on tables A6(b) and A6(c) of the International Labour Organization, 2009, Global Employment Trends for Women (Geneva).


16. As with the sectoral distribution of value added, a key topic to explore further is the trajectory of industrial employment, as it is this sort of employment that has been the main avenue by which both women and men have typically accessed the better paid and formal jobs associated with growth and development. In addition, as services are increasingly the main source of employment in countries at all levels of development, yet also form a very heterogeneous sector, it is important to better understand their potential to generate decent work.

II. Industrial policy in a changing environment

17. Successful economic transformation in developing countries has generally benefited from a favourable external economic environment characterized by buoyant global demand and/or the effective use of policy instruments in support of industrialization. With the risk of secular stagnation in developed countries likely to limit the demand for developing countries’ manufactured exports for a protracted period of time, developing countries will need to adapt their development policies to attain the goals of an ambitious transformative post-2015 development agenda. In this context, industrial policy is a relevant element in multilateral approaches and global partnerships in support of attaining the Sustainable Development Goals.


6 UNCTAD, 2015b.
18. Today’s advanced economies have employed active industrial policies to support, direct and coordinate the processes of capital accumulation and structural transformation (as also seen in recent success stories in the developing world). This is not synonymous with public ownership or the selection of winners, although these methods have been used by practically all economies. Rather, it is part of a process of coordinated search and discovery, whereby Governments and firms uncover market failures, learn about the underlying costs and profit opportunities associated with new activities and technologies, evaluate the possible externalities associated with particular projects and use the acquired information and skills to push towards a more diversified and higher value added economy. Successful industrial policies have often targeted the expansion of capital and knowledge-intensive sectors with high technological sophistication, supported strategic forward and backward linkages and aggregate demand growth, and relaxed balance-of-payments constraints through the creation of new competitive advantages. Such strategic sectors tend to be concentrated in manufacturing. However, as these features are present in other sectors of the economy in many developing countries, particularly in the least developed countries, such policies will more likely depart from priority areas in agriculture, because of their economic significance, potential linkages to other sectors, importance for the balance of payments and the fact that large numbers of poor people still live in rural areas. 

19. Sustainable development strategies have also, albeit with appropriate limits, aimed at constantly pushing the technology frontier by incorporating selected high-productivity projects with a more advanced technological and skills profile and with higher levels of research and development. Doing so is often linked to investments in tertiary education or science parks, or to efforts to attract a skilled diaspora abroad with the hope that there will be transfers of expertise elsewhere by changing jobs or opening small businesses. UNCTAD has stressed that a national innovation strategy can help coordinate the various activities and policies, in both the private and public sectors, in support of the stronger knowledge and learning capacities that are needed to close technological gaps.

20. At all levels of development, strengthening non-tradable sectors also has a role to play in ensuring sustainable and inclusive growth. Such sectors include infrastructure (roads, ports and airports, electricity generation and transmission lines, housing, water and sewerage provision), which might benefit from large-scale public works programmes, and lower productivity sectors, including construction, repair workshops and non-durable consumer goods industries, which have a significant employment-generating potential and train entrants to the labour markets. In these sectors, there are potential trade-offs between boosting productivity and expanding employment. How best to manage such trade-offs cannot be determined outside particular circumstances.

21. Recent years have seen a renewed interest in industrial policies. Many developing countries have adopted new initiatives or adapted older ones, often addressing the challenge of fostering greater domestic linkages for structural change and building international competitiveness. Specific tools differ among different countries, but they usually involve incentives to increase investment in priority sectors, for example the automotive industry and export incentives in Brazil, infrastructure and critical industrial sectors in India and priority industrial clusters in Indonesia. Such policy measures targeted at expediting industrialization have often been pursued in an effort to replicate the successful economic transformation of the East Asian economies, but in some instances have been adopted due to the fear of falling behind through premature deindustrialization. This fear has been discussed under the term middle-income trap, which denotes the fact that countries have found it increasingly difficult to diversify beyond the low-productivity stages of manufacturing. Such risks have appeared either in the context of Washington Consensus-

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inspired policies since the 1980s or of sizeably increased commodity export earnings in more recent years. Active policies on the supply side may also seek to adapt the productive capacities of developing countries to a changing pattern of demand, with a larger role for domestic and regional demand (vis-à-vis exports to developed countries) and, in some countries, a higher share of private and public consumption and lesser participation by fixed investment, such as in China.\(^9\)

22. Moreover, many developed countries have come to explicitly acknowledge the important role that industrial policy can play in developing clean technologies and maintaining a robust manufacturing sector with a view to reaping the associated benefits for productivity growth, innovation and employment.\(^10\) Part of this has been an effort to stem the inroads of developing countries into global manufacturing. However, especially in the wake of the onset of the global financial crisis and recession, advanced economies have recognized that those based mainly on services activities (especially in construction, retailing and finance) appeared to be more vulnerable to adverse external shocks than those with a sizeable manufacturing base.

23. The use of industrial policy has sometimes been judged undesirable even when a particular country’s specific constraints to transformation and industrialization can be identified. This is because of doubts as to the presence of the management capacities required to implement and enforce industrial policies within specific institutional contexts. However, notwithstanding implementation challenges (for which many developing countries require technical assistance and capacity-building), a combination of positive and negative reinforcement, such as by introducing performance measurement for economic programmes or by institutionalizing feedback mechanisms from targeted groups back to public service providers, can and should provide an appropriate governance framework that allows identified policy options to be implemented and enforced in a cooperative climate between Government and corporations.\(^11\) Such a governance framework also needs to ensure that industrial policy is part of a coherent development strategy and has mutually reinforcing links with a Government’s other economic policies.\(^12\)

24. Structural economic transformation needs the support of social actors, and at the same time modifies the social structure and the economic and political weight of different agents. Such social and political aspects of economic transformation must be taken into consideration, as they are essential for the sustainability of a development strategy. The respective roles of small and medium-sized and large enterprises as sources of value added, employment, income, exports and productive linkages, as well as the interrelations among them and with the State, are therefore a key topic that the third session of the Multi-year Expert Meeting may wish to discuss.

25. The recent adoption of new industrial policy initiatives has benefited from the fact that multilateral trade agreements have maintained some flexibilities in terms of pursuing the trade and industrial policies that policymakers deem most suitable to achieving structural transformation and industrialization, and also from some special and differential


\(^12\) JM Salazar-Xirinachs, I Nübler and R Kozul-Wright, eds., 2014.
treatment for the least developed countries that such agreements provide. On the other hand, the pursuit of industrial policy has increasingly been constrained by bilateral or regional trade and investment agreements, as well as by private standards that may be imposed by lead firms in global value chains or by strong industry associations.13

26. This suggests the need to support achieving the new ambitious transformative development goals through strengthened global partnerships that reinforce inclusive multilateral mechanisms that preserve, and preferably expand, the policy space of developing countries.14 The adoption of a more robust South–South integration architecture could also support the post-2015 development agenda. The opportunities to explore the contribution of South–South cooperation are another issue that the third session of the Multi-year Expert Meeting may wish to discuss.

III. Challenges ahead

27. The current lack of dynamism in the largest developed economies is a major constraint to continued growth in the developing world. Developing economies can no longer depend on developed economy markets for growth to the extent that they have done in the past.15

28. In this context, one key challenge currently faced by developing economies is that of rebalancing their growth drivers. Some Asian economies are taking steps in this direction, with growing domestic markets enabling the adoption of more domestically and regionally oriented growth strategies. Economies based in other geographical areas, however, are lagging behind. Furthermore, reliance on domestic markets is limited by market size, particularly for smaller economies.

29. Many developing countries, and especially the least developed countries, are also facing the critical challenge of low and stagnating productivity. Low productivity is particularly acute in agriculture, as productivity is held back by a range of constraints such as small farm sizes and weak infrastructure and other constraints related to human capital, technology and credit access. However, the manufacturing (for example, assembly plants) and services (for example, informal retail trade) sectors are also marked by a large number of low-skill, low-productivity jobs in many developing countries. This should be taken into consideration in evaluating how integrating into regional and global value chains can best spur industrialization, diversification and productivity growth in manufacturing.

30. Participation in international production networks can provide an opportunity for nascent industries in developing countries at an early stage of industrialization to engage in higher value added production, which can help developing countries expand employment, raise incomes and accumulate basic skills and other capabilities that are required to pursue industrialization involving technologically more sophisticated manufacturing activities.

31. In the last two decades, upgrades in transport infrastructure, logistics and cross-border trade facilities, together with improvements in the business environment, trade and investments, have enabled a number of developing countries to deepen their productive capacities. However, climbing the value addition chain is neither an automatic nor an easy process. Indeed, developing countries with limited productive capacities can remain trapped in, and competing for, the lowest value added activities at the bottom of regional and global value chains, and breaking out of such traps requires active policies to boost productive capacities, widening the productive base and making it more competitive.16 Without proper

13 UNCTAD, 2014.
14 Ibid.
15 UNCTAD, 2013; and UNCTAD, 2015a.
industrial policies, therefore, this first step towards industrialization may also be the last one. Governments need to actively promote, and have the means to put in place, measures for creating local spillovers and supporting local integration. Otherwise, participation in global value chains will not generate upgrades in domestic production, threatening instead the formation of a middle-income trap. An alternative to such demand and supply problems relies on increasingly drawing on domestic sources of demand as new engines of growth, while at the same time promoting development in key productive sectors (particularly in manufacturing and modern services) through active industrial policies and strategic integration in regional and global trade.

32. Productive diversification, technological upgrading and structural change are key to generating greater and sustained growth, as they increase the range of national products to meet the needs of domestic demand and contribute to the expansion of demand itself through increased employment and rising wages based on productivity gains. Foreign markets, in turn, would complement domestic markets, which is vital to avoiding balance-of-payments bottlenecks. In this regard, and in view of the loss of dynamism in developed markets, it is important that developing economies fully explore the opportunities that exist in the developing world. In order to achieve this goal, South–South cooperation can help create a regional space for industrialization and new markets, particularly for manufactured products.

33. The selection of specific sectors and industries for policy support is an additional challenge, and varies from country to country according to their strengths and potential for upgrading and dynamic comparative advantages. In this context, a developmental State is needed to direct resources from low to higher productivity sectors. It is crucial to ensure that the State remains efficient and effective through targeted industrial policy and incentive measures for strategic sectors. Regulation to address market failures and distortions, and promote private sector development, is especially important.

34. Finally, it is important to stress that developing countries today are designing their industrial policies in a more constrained global environment than in the past when, for instance, the East Asian outward-oriented industrialization of 20 to 40 years previous combined the protection of infant industries with market discipline by conditioning State bank financing to export performance. However, the extensive use of import tariffs as a tool of protection may currently be constrained by the World Trade Organization and other regional and bilateral trade agreements. Developing economies therefore need to maximize the use of policy space by adopting innovative policies or policy tools less subject to restrictions by international agreements, and by forging new pathways for industrial development and economic transformation. It is thus essential that they maintain sufficient policy space to pursue development strategies.

35. Bearing in mind some of the considerations presented in this note, the third session of the Multi-year Expert Meeting is invited to take note of the strategic role of developmental industrial policy in support of productive capacity, and may wish to consider the following questions:

1. Is industrialization still a central target in structural change and productive diversification?
2. How should the recent initiatives in the field of industrial policies be evaluated?
3. What are the roles of domestic and external markets?
4. How can income and social policies promote inclusion (particularly of women and youth) and strengthen domestic markets?
5. What are the effects of productive diversification on employment?

17 UNCTAD, 2014.
18 UNCTAD, 2015c.
6. Are active policies by a developmental State needed and, if so, which ones?

7. How should infrastructure services be linked to manufacturing development and industrialization?

8. How do industrial policies in developed countries impact on the international trade of developing countries?

9. How can policies aimed at productive diversification affect the economic and social structure (including public and private sectors, small and large enterprises and rural and urban areas)?