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OVERVIEW
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Overview

A CONSTRUCTIVE NEW BEGINNING OR BUSINESS AS USUAL?

In the early 1990s, there was a widespread expectation that the globalization of production systems and of finance, and the liberalization of economic activity, would promote diminishing income disparities between countries within the global economy. For the least developed countries, the prospect that the removal of legal and political obstacles to trade and capital movements would lead to accelerated growth and income convergence with more advanced countries was particularly inviting. During the 1990s there has been an accelerating process of economic liberalization in many least developed countries (LDCs). However, overall progress in increasing real incomes, reducing poverty and moving towards various international targets for human and social development has been disappointingly slow, except for a few of them.

A radical rethinking of international development cooperation, of profound significance for the LDCs, is currently under way. At the multilateral level, the IMF has undertaken two major evaluations of its lending operations for low-income countries. On the basis of their findings it has transformed its Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility (PRGF), and is now attempting to re-engineer the way it operates in poor countries. The World Bank has similarly conducted in-depth evaluations of its experience with adjustment lending. Adjustment policies have now been pursued in many poor countries for as many years as the earlier import substitution industrialization policies, and the World Bank has sought to create a new development paradigm which draws on the lessons of both periods. The new paradigm is embodied in its Comprehensive Development Framework and elements of this are now being put into practice by making poverty reduction strategies the basis for concessional lending to low-income countries through the IDA, and debt relief to highly indebted poor countries. Furthermore, the OECD has thoroughly reassessed the effectiveness of bilateral development assistance, and made comprehensive proposals for improving development cooperation through application of the principles of partnership and policy coherence. Its report, *Shaping the 21st Century: The Contribution of Development Co-operation*, has stimulated reflection and innovation in bilateral aid policies in many donor countries.

This rethinking is a response to two major trends of the 1990s. The first comprises globalization and liberalization. The second is the uneven distribution of the costs and benefits of these processes. The number of people living in poverty is increasing in various regions of the world, and the poorest countries are failing to catch up with developed and other developing countries, and some are getting stuck in vicious circles of economic stagnation and regress.

The group of least developed countries contain the hard core of the problem of marginalization in the world economy. A new approach to international development cooperation is essential if this situation is to be rectified, and it is for this reason that the current rethinking is so important for the LDCs. However, it is vital that the new approach should actually be a constructive new beginning rather than business as usual. Some preliminary assessments of the changes being made suggest that these are symbolic rather than substantial, but this Report does not subscribe to that point of view. There are serious changes being made in international development cooperation. But it is debatable whether they are wholly right. The new approach is still in the making, and the central question which both LDCs and their development partners must therefore keep in the forefront is, “Why should we expect better results this time around?”. Moreover, the central disposition which they must cultivate as they construct the new approach is, “How can we ensure that we achieve better results this time around?”.

For the 614 million people currently living in LDCs, the stakes are high. If the average growth rate of real GDP per capita achieved by individual LDCs in the period 1990–1998 continues into the future, only one out of the 43 LDCs whose GDP per capita is below $900 - which is currently one of the criteria for graduation from the category of LDC - will reach that threshold before the end of 2015, and only eight countries will reach it in the next 50 years. An increasing number of the 22 LDCs where real GDP per capita either declined or was stagnant during the period 1990–1998 can be expected to become caught in a situation in which economic regress, social stress and political instability interact in a vicious circle. Even for those LDCs which are growing, there will be an ever-present danger that external shocks, natural disasters, or negative spillover effects from neighbouring LDCs, will disrupt economic activity and throw them off their fragile growth trajectories. In this scenario, the LDCs will become pockets of persistent poverty in the global economy. Moreover, with continued international commitment to a two speed liberal economic order, in which policies to facilitate the free movement of goods and capital are vigorously pursued whilst equivalent measures to facilitate the free movement of labour are discouraged, the citizens of LDCs will increasingly face an unenviable choice between either poverty at home, or social exclusion abroad, as illegal workers or second-class citizens in other countries.

If, on the other hand, a new approach to international cooperation creates an appropriate international enabling environment and fosters more effective national development policies, it is possible to envisage an economic take-off occurring in an increasing number of countries and their graduation from the LDC category. According to this scenario, there will be a progressive transition in which sustainable growth is increasingly founded on domestic resource mobilization, the attraction of developmental FDI and the tapping of international financial markets, while vulnerability to shocks, and to associated social stress, declines.

THE OPPORTUNITY OF UNLDC III

This Report has been prepared with a view to the Third United Nations Conference on the Least Developed Countries (UNLDC III), which will be held at Brussels in May 2001. UNLDC III will be an important forum in which the special problems of the least developed countries are brought into prominence in the hope that changes in international cooperation adequately address their development needs. The Conference will be a major opportunity for the LDCs and their development partners to devise practical mechanisms of partnership and policy coherence. This Report is intended as an input to those discussions. It aims to provide a better substantive basis for an approach to international development cooperation which will facilitate a progressive transition in which the LDCs build up productive capacities and international competitiveness, and rely increasingly on domestic resource mobilization and private capital inflows for their development finance needs.

The Report complements and builds on the Least Developed Countries Reports (*LDCR*s) of the last two years, which were concerned, respectively, with the place of LDCs in the multilateral trading system and the problem of market access (*LDCR 1998*), and with the need to develop productive capacities in the LDCs and national policies which could facilitate that process (*LDCR 1999*). This Report briefly reviews economic growth and social trends in the 1990s. But it focuses in particular on the question of financing development in the least developed countries. This is essential not simply for addressing the pressing social needs of these countries. It is vital for accelerated economic growth and the development of productive capacities, for successful structural adjustment and integration into the world economy, and for reduced vulnerability to external shocks and natural disasters.

In order to facilitate discussions at UNLDC III, the Report discusses the scale of the development finance challenge in LDCs, the scope for meeting this challenge through domestic resource mobilization, and the constraints which are limiting the LDCs' access to international capital markets and attractiveness for FDI. From the analysis, two key features of the development financing patterns of LDCs emerge. First, the central accumulation and budgetary processes of the LDCs are dominated by external rather than domestically generated resources. Second, almost all the external finance for most LDCs comes from official sources. The development prospects of most LDCs thus still depend critically on aid relationships and associated external debt dynamics. The Report examines how these have been working in the 1990s and whether the current rethinking of international development cooperation is likely to rectify the deficiencies of the past.

The main analytical conclusion of the Report is that *the current diagnosis for change which is shaping the new approach to international cooperation is flawed in several crucial respects.*

This conclusion merits careful consideration. If the diagnosis is right, and changes are made accordingly to national and international policies, the new approach to international cooperation will increase the probability that more and more LDCs will move into the take-off scenario in which domestic resource mobilization increases, FDI is attracted and access to international finance markets is opened up. But if the diagnosis is wrong, with whatever ingenuity the implied policy changes are made, and with whatever energy and good faith they are implemented, there is no reason why we should expect better results this time round. The most likely outcome at the end of the coming decade will be a new round of aid fatigue for the new approach and a new round of debt relief to pay off the latest wave of ineffective official loans.

It is imperative for UNLDC III to end up with policy proposals and commitments that are based on a correct diagnosis of the weaknesses of past domestic and international policies. The Report is oriented to that end, and it makes constructive proposals for improving international cooperation for LDCs in the field of development finance in a way which can, in the end, facilitate a progressive transition away from aid dependence.

THE ANATOMY OF THE DEVELOPMENT FINANCE PROBLEM IN THE LDCs

One of the main weaknesses of discussions of development finance is that too little attention is paid to the heterogeneous nature of developing countries. The Report thus seeks at the outset to set out the main features of the development finance problem of the LDCs by comparing their patterns of domestic resource mobilization and reliance on external finance with other developing countries as well.

The evidence over the long term shows that when per capita income increases in LDCs, there is a strong domestic savings effort. Indeed, the development effort in LDCs, as measured by the degree to which extra income is saved, is at least as strong as in other developing countries. If growth can be sustained, therefore, significant increases in domestic resource mobilization may be expected which would, in due time, reduce dependence on external finance and usher in the possibility of a more self-sustained growth process.

However, because of the very low income per capita of most LDCs and their sluggish or even negative per capita growth rates, this potential for domestic resource mobilization is not being realized. With many people living from hand to mouth, and with a very weakly developed corporate sector, domestic savings are necessarily very low. This not only limits domestically financed economic growth but is also a fundamental source of the vulnerability of LDC economies. The size of the external shocks in the LDC economies, in terms of income losses inflicted, are often many times the size of the resources that these countries can muster internally to cope with such shocks. Indeed, in relation to the domestic resources available for finance, the average LDC economy has, since the 1970s, been exposed to adverse external trade shocks with an impact, in the worst years, more or less double the average of other developing countries.

Despite the extremely low levels of domestic resources available for financing purposes, the LDCs have managed to some extent to raise their investment levels. In doing so they have relied heavily on external finance. However, investment and public expenditure in the African and Asian LDCs as a share of GDP is still well below the average of non-LDC developing countries, indicating inadequate access to external sources of finance. In the light of the special needs of the LDCs – given their very low levels of socioeconomic infrastructure, high degree of vulnerability to external shocks, high rates of environmental depletion, as well as high rates of human capital resource depletion arising from the prevalence of diseases such as AIDS – this implies a serious underinvestment in these economies. The low level of investment is likely in itself to have harmed the efficiency of any investment made.

The LDCs are thus caught in a trap, with low incomes and slow growth limiting the scope for domestic resource mobilization, and low rates of investment and low efficiency of resource use in turn limiting growth. The only way to escape is through external finance.

Possible sources of external finance include, on the one hand, official capital flows, in the form of grants or loans, provided by bilateral and multilateral aid agencies, packaged with or without technical assistance, and, on the other hand, private capital flows, from sources which include banks, capital markets, companies and individuals, taking the form of short- and long-term loans, acceptance of company and government bonds, portfolio and direct investment. But in spite of the globalization of production and finance which has been occurring in the 1990s, only a few LDCs have been able to attract significant private capital inflows.

The reasons why foreign investors and lenders are deterred from placing their money in many LDCs are related to costs of asset development, risks which are rooted in the vulnerability of LDCs to shocks, lack of business support services, weak physical, social and administrative infrastructure, and the small scale of most projects. International capital markets are also characterized by imperfections which limit LDCs' access to private finance even when projects are economically viable. Economic growth seems to be a key factor which affects whether developing countries can attract private capital inflows. Thus, just as with domestic resource mobilization, one may envisage a virtuous circle getting under way if growth can be sustained in the LDCs, and in this way, FDI and private credit could in the long run substitute for official grants and official debt-creating flows. But for the moment, ODA is the major source of external finance, and the LDCs and their development partners are dependent on using aid to break out of the vicious circle of low incomes, low savings and inadequate investment in which many LDCs are caught.

THE RECORD OF THE 1990S

Economic growth and social trends

The real GDP of the LDCs as a group grew by 3.2 per cent per annum during 1990–1998, as against 3.4 per cent for the low- and middle-income countries as a whole and 2.5 per cent for the world. This was a minor improvement over the economic performance in the 1980s. Moreover, the gap between the LDC growth rate and the growth rate of other developing countries also narrowed in the 1990s. However, a significant part of the aggregate LDC growth is attributable to a single country, Bangladesh, which accounts for a quarter of the economic size of the LDC group, and which grew at higher and more stable rates than most other countries in the group. The growth rate for the LDCs without Bangladesh was 2.4 per cent during the period 1990–1998. Also, the population growth rate for LDCs was significantly higher than the developing country average, and almost double that of the world average. Taking this into account, real GDP per capita in the LDCs grew at only 0.9 per cent per annum during 1990-98, and excluding Bangladesh, by only 0.4 per cent per annum.

This does not compare favourably with the real GDP per capita growth rates in other developing countries which were 1.9 per cent per annum during the 1980s, and 3.6 per cent per annum during 1990–1998. During the 1980s, the simple average of the per capita growth rates in the other developing countries was double that of the LDCs, and in the period 1990–1998 it was four times higher than that of the LDCs. This indicates a growing average per capita income gap between the LDCs and other developing countries. Compared with low-income countries, the overall growth performance of the LDCs as a group also appears slow. Per capita GDP in low-income countries, largely because of high rates of growth in China and India, increased at annual rates of 4.3 per cent and 5.4 per cent during the 1980s and the 1990s respectively. This indicates that the LDCs are being rapidly overtaken by other low-income countries.

There are, however, important divergences among LDCs. There is a group of 15 LDCs where real GDP per capita growth exceeded 2 per cent per annum during 1990-1998. Of these, seven are in Asia. At the other end of the spectrum there are 22 LDCs which have been stagnant or in economic regress during the same period. In eleven of these, all of which have experienced serious armed conflicts and internal instability during the 1990s, the real GDP per capita has been declining by over 3 per cent per annum over this period. Overall, 32 LDCs have either relatively fallen behind the other developing countries in terms of per capita income, or have experienced absolute deterioration in living standards, during 1990-98.

Within the overall economic performance in the 1990s, there are significant differences between the early and the later part of the decade. For the LDCs as a whole the growth of real per capita GDP was low and declining each year in the early 1990s, but it jumped significantly and became positive in 1995. Since then, it has been relatively high but declining each year. The turning point corresponds to the most sustained improvement in the terms-of-trade of the LDCs since the early 1980s. Between 1988 and 1993, the terms-of-trade of the LDCs on average fell by about 12 per cent, but in 1994–1995 there was an upturn that was sustained until 1997.

The terms-of-trade of the LDCs worsened in 1998 and 1999 with a drop in commodity prices whose breadth and depth has not been seen since the early 1980s. The composite index of non-oil commodity prices fell by more than 30 per cent during the period 1998–1999. However, the price index of crude oil, which dropped by over 30 per cent in 1998, has increased sharply since early 1999, and has witnessed a more than threefold increase between March 1999 and August 2000.

The implications of commodity price changes for the terms-of-trade of different LDCs has been varied, of course, depending on the nature of their trade specialization and the composition of their imports and exports. During 1998, the oil-exporting LDCs were hard hit, while the impact of the pervasive primary commodity price declines on oil importers was to some extent alleviated because of cheaper oil prices. Since March 1999, however, the precipitous increase in oil prices has benefited the oil exporters, while the non-oil primary exporters have been doubly hit by low primary commodity prices and rising fuel import bills. Some of the small island LDCs which have specialized in services exports (e.g. Maldives), or Asian LDCs which have specialized in manufacturing exports (e.g. Bangladesh), are expected to be less adversely affected by the primary commodity price declines than by the increase in oil prices. In general, the decline in the terms-of-trade since 1998 has been particularly severe for the primary commodity exporting and oil importing countries, i.e. the majority of the LDCs.

The social trends in the LDCs in the 1990s are mixed. But three features give cause for concern. First, economic growth was too slow in most LDCs to make a significant dent in the unacceptably high rates of poverty. Second, whilst significant social achievements were being made in a few countries, the rates of social progress have generally lagged behind those required to meet the international goals established at the global summits of the 1990s, and the gap between the LDCs and other developing countries is often widening. Third, almost a quarter of the LDCs are caught in a downward spiral in which economic regress, social stress and violent conflict mutually reinforce each other.

The Paris commitments

In 1990, as an outcome of the Second United Nations Conference on the Least Developed Countries (UNLDC II), which was held at Paris in September 1990, the international community committed itself to urgent and effective action to arrest and reverse the deterioration in the socioeconomic situation in the least developed countries and to revitalize their growth and development. The commitments, set out in the Paris Declaration and the Programme of Action for the Least Developed Countries for the 1990s, are wide-ranging, but at their heart there was an implicit partnership. The LDCs undertook to deepen the process of economic reform which they had begun in the 1980s, whilst their development partners undertook to make available a significant and substantial increase in the aggregate level of external support to the LDCs.

The record of the 1990s shows that there has been an accelerating process of economic liberalization in many LDCs. In fact 33 out of the 48 LDCs have undertaken policy reforms under the IMF-financed Structural Adjustment Facility (SAF) or Enhanced Structural Adjustment Facility (ESAF) programmes since 1988. The main exceptions to this movement are LDCs which are ineligible as their per capita incomes are too high, or States that have experienced severe civil conflict or sanctions by the international community. Amongst those LDCs which have initiated reforms, the process has, of course, been deeper and longer in some than in others, and it has also been carried out with numerous intermittent interruptions. But one third of the LDCs involved have been in these programmes for over half the time between the beginning of 1988 and the end of 1999, and 27 countries have been engaged in implementing the agreed policies for three years or more during that period. Reforms have also been stronger in some domains than in others. But the available evidence suggests that the LDCs have kept up with other developing countries in the process of structural reform in all areas except financial sector reform and the reform of the public enterprise sector, and they have gone further than other developing countries in the area of pricing and marketing reform. When slippage on policy commitments did occur, it was more often than not due to missing fiscal targets than reneging on structural reforms. Indeed, the only systematic hard evidence on causes of programme interruptions shows that, for the LDCs, slippage on policy commitments related to structural reform was a cause of programme interruptions in less than 15 per cent of the interruption episodes.

As a consequence of these reforms, the policy environment in many LDCs changed significantly in the 1990s. IMF data actually show that trade liberalization has proceeded further in the LDCs than in other developing countries. In 1999, for 43 LDCs for which data are available, 37 per cent had average import tariff rates of below 20 per cent coupled with no or minor non-tariff barriers, whilst amongst the 78 other developing countries in the sample, only 23 per cent had this degree of openness. Indeed, 60 per cent of the 43 LDCs had average tariff barriers which were below 20 per cent and non-tariff barriers which were moderate in the sense that they were not pervasive, covering less than 25 per cent of production and trade. Similarly, UNCTAD data for the late 1990s show that, in a sample of 45 LDCs, only 9 maintain strict controls on remittances of dividends and profits and capital repatriation. Twenty-seven LDCs have adopted a free regime, guaranteeing such transfers, whilst nine have a relatively free regime, either by controlling capital repatriation (while allowing free remittances of dividends and profits) or requiring the Government's prior authorization of such transfers.

Whilst the process of economic reform in the LDCs has been widespread and in many cases deep, the implementation of the external finance commitments made in Paris in 1990 has been weak. In order to reach, as soon as possible, a flow of concessional resources commensurate with the increase called for, donors agreed to seek to implement the following targets:

- Donor countries already providing more than 0.20 per cent of their GNP as ODA to LDCs: continue to do so and increase their efforts;
- Other donor countries which have met the 0.15 per cent target (set by the Substantial New Programme of Action for the Least Developed Countries for the 1980s): undertake to reach 0.20 per cent by the year 2000;
- All other donor countries which have committed themselves to the 0.15 per cent target: reaffirm their commitment and undertake either to achieve the target within the next five years or to make their best efforts to accelerate their endeavours to reach the target;
- During the period of the Programme of Action, the other donor countries: exercise their best efforts individually to increase their ODA to LDCs so that collectively their assistance to LDCs will significantly increase.

In practice, the share of aid to LDCs in DAC donors' GNP fell from 0.09 per cent in 1990 to 0.05 per cent in 1998, and in that year only five DAC members met the targets of the Programme of Action, namely Denmark, Luxembourg, the Netherlands, Norway and Sweden.

As a consequence, aid flows to the LDCs have been declining, particularly since 1995. Net ODA from DAC countries is estimated to have been $12.1 billion in 1998, down from $12.6 billion in 1997. For the LDCs, the decline in 1998 was the third year of uninterrupted decrease, representing a cut of more than $4.5 billion since 1995. The decline in 1998 contrasts with the more positive developments in ODA to developing countries as a whole in that year. Net ODA to all developing countries increased by almost $2 billion from 1997 to 1998, breaking the steady decline since the early 1990s. From a longer-term perspective, it is apparent that in nominal terms there was an increase in net ODA to LDCs in the second half of the 1980s. In fact, net ODA increased by 73 per cent in nominal terms over the period 1985–1990. The post-1995 decline reverses this trend, taking net ODA back below the level which it was at in nominal terms in 1987. In real per capita terms, net ODA to LDCs has dropped by 45 per cent since 1990 and is now back to the levels at which it was in the early 1970s.

The new private capital inflows

The declining aid flows to the LDCs give particular cause for concern because of the multiple investment requirements for sustained economic growth and poverty reduction in the LDCs, the limited scope for meeting those needs through domestic resource mobilization, and the inability of the LDCs to attract large inflows of FDI and other private capital. There are indeed positive signs that private capital inflows into the LDCs are actually increasing. Aggregate trends obscure this fact as they are dominated by what is happening in four LDCs – Angola, Equatorial Guinea, Myanmar and Yemen – where oil and gas development is taking place, which absorbed 80 per cent of private capital inflows during the period 1990–1994. But if these countries are taken out of the sample, it is apparent that long-term private capital inflows into the LDCs have increased from $323.1 million per annum during the period 1990–1994 to $941.9 million during the period 1995–1998, according to World Bank data. Average inflows in the late 1990s were higher than in the early 1990s for 29 out of 45 LDCs for which data are available.

However, although these trends are positive, large increases in private long-term capital inflows to LDCs are concentrated in just a few countries. In fact, about three-fifths of the increase in private capital inflows between the early and late 1990s noted in the last paragraph has been concentrated in four countries – Cambodia, Lao People's Democratic Republic, Uganda and United Republic of Tanzania. Uganda in particular illustrates the beneficial consequences of an upward growth spiral for private capital inflows, and Cambodia and the Lao People's Democratic Republic benefited, until 1997, from the regional dynamics of East Asian growth and industrialization. For most LDCs, private capital is also generally such a small proportion of total capital inflows that even where private capital inflows have been increasing they have been unable to offset the decline in official finance in most LDCs. There are in fact only three LDCs where the increase in net private capital inflows was sufficient to offset declining net official finance. Also, it is apparent that the LDCs are failing to attract certain types of private capital. In the early 1980s, long-term international bank finance to LDCs collapsed and it has failed to recover. These countries have also been bypassed by portfolio equity flows, and by bond issues. FDI also remains highly focused on natural resource exploitation.

The overall effect of the inability of most LDCs to attract sufficient private capital inflows to offset declining aid is naturally a decreasing supply of external finance to the LDCs. Long-term capital inflows into the LDCs as whole have declined by about 25 per cent in nominal terms since 1990, and if the import price index of LDCs is used to deflate current values (i.e. to express them in terms of their purchasing power over foreign goods), long-term net capital inflows are back to the level of the 1980s, and real per capita long-term capital inflows are down by 39 per cent since 1990.

The pattern contrasts markedly with what is happening in other developing countries. Whilst long-term net capital inflows into the LDCs have declined, capital inflows into other developing countries have increased dramatically in the 1990s, as private capital flows have come to dominate total flows. As a consequence, the LDC share in aggregate net resource flows into all developing countries has fallen dramatically. After peaking in 1987 at 18 per cent, the share has fallen to less than 4 per cent of total long-term net capital inflows into all developing countries. The share of net FDI received by LDCs has fallen from 3.6 per cent in the period 1975–1982 to 1.4 per cent in the 1990s. Moreover, LDCs are largely rationed out of portfolio equity flows, bonds and commercial loans without a government guarantee.

The persistent external debt burden

A measure of the weakness and fragility of the economic performance in the least developed countries in the 1990s is the persistent external debt burden. For LDCs as a whole, according to World

Bank statistics, the nominal value of the total external debt stock rose from $121.2 billion in 1990 to $ 150.4 billion in 1998, and the total debt service paid by the LDCs amounted to $4.4 billion in 1998 as compared with $4 billion at the start of the decade. Total debt stocks corresponded to an estimated 101 per cent of their combined GNP, up from 92 per cent in 1990. Half of this debt stock was concentrated in just six countries – Angola, Bangladesh, Democratic Republic of the Congo, Ethiopia, Mozambique and Sudan – and in 23 out of the 45 countries for which data are available, external debt stocks in nominal terms were less than $2 billion. Yet using the criteria which the international community has recently adopted under the enhanced HIPC Initiative to judge debt sustainability, it is apparent that in 1998 the external debt was unsustainable in 27 of the 42 LDCs for which data are available. Moreover, leaving aside the island LDCs, which have rather special development financing patterns, two-thirds of the LDCs are entering the millennium with levels of external indebtedness which are unsustainable even after the full deployment of traditional (pre-HIPC) debt relief mechanisms.

The persistent external debt burden greatly aggravates the task of escaping from the low-income trap which is at the heart of the development finance problem in the LDCs. High levels of external debt constrain domestic investment in various ways. Debt service payments absorb foreign exchange and thus reduce capacity to import capital goods. As much of the external debt is owed by government, debt service payments also reduce government expenditure on essential public services. The debt overhang creates uncertainty for domestic and foreign investors. It adversely affects country credit ratings and perceptions of country risk, limiting the access of potentially profitable firms within indebted countries to international capital markets.

The LDCs which have a serious debt problem have also become increasingly reliant on “exceptional financing” in the form of a reduction in actual debt service payments in any given year below those which are contractually due. Although measurement is difficult, it is clear that many LDCs are now highly dependent on these “virtual financial flows”, which come either through formally negotiated debt relief which reduces the stream of debt service payments or through the disorderly accumulation of arrears. Indeed, if these “virtual financial flows” were not supplementing the actual flows, aggregate net transfers to LDCs as a whole would have been just 31 percent of their actual level during 1989–1993 and only 25 per cent of their actual level in 1994–1998. It is also estimated that exceptional financing has been critically important for a wide range of countries. Indeed, during 1989–1993, it constituted more than 2 per cent of GNP in more than two-thirds (25) out of the 38 LDCs for which data are available, and during 1994–1998, it constituted over 2 per cent in more than half (23 out of 41). For many severely indebted LDCs, “virtual financial flows” have become the main source of external finance after ODA. Although it is not helpful to treat such exceptional financing as a form of development finance, in practice, debt relief has started to function as such, which is making it natural for debt relief and ODA to be treated as analogous forms of assistance, and for ODA to be diverted into debt relief.

GETTING THE DIAGNOSIS FOR POLICY CHANGE RIGHT

The rethinking of international development cooperation which is underway is indicative of the fact that there is a widespread dissatisfaction with progress in the 1990s, and a widespread concern to do better in the coming decade. These concerns are justified. However, in order to get things right this time round, it is necessary to ensure that the current diagnosis for policy change is right. This demands a closer, and constructively critical, look at its key propositions.

The current diagnosis for policy change

The diagnosis for policy change which is currently guiding the rethinking of international development cooperation can be summarized as eight central propositions.

- The relatively weak economic response to policy reforms in low-income countries is a result of poor implementation rather than inadequate policy design or underfunding. Poor implementation in turn reflects the impossibility of rigorously enforcing policy conditionality, and thus allowing Governments that did not wish to implement economic reforms vigorously to get away with it.
- Aid will work if the national policy environment is right.
- The fundamental elements of the right national policy environment are present when Governments: (a) pursue macroeconomic stability by controlling inflation and reducing fiscal deficits; (b) open their economies to the rest of the world; and (c) liberalize domestic product and factor markets through privatization and deregulation.
- Insufficient attention was given in the past to the achievement of social objectives. Social policies, which should aim to ensure that development is more pro-poor, should thus now be integrated with the macroeconomic policies and structural reforms that define the right national policy environment.
- National policy will be most effective if donors are not in the driving seat and there is national ownership of policy. Ownership in this context means that Government, through a participatory process, takes the lead in the preparation of the strategic programme document which will guide the economic reform process and whose implementation will later be monitored as a condition for aid and debt relief.
- Aid effectiveness can also be increased if donors focus their aid on countries that have the right policies, i.e. increase the geographical selectivity of aid flows.
- Aid effectiveness can be increased by improved coordination between the IMF and the World Bank, and also amongst bilateral donors. The strategic documents prepared by the Government should provide a framework for this.
- External debt is a problem for highly indebted poor countries. But the debt relief provided through the HIPC Initiative will be sufficient to provide a sustainable exit from debt problems and will be effective in reducing poverty as long as the national policy environment is right.

Diagnosis for policy change: an alternative view

The issues of reorienting national policies, promoting national ownership and partnership, and increasing aid coordination are certainly the right ones. But the current diagnosis for change is too rooted in a perspective which locates past problems at the national level rather than in international economic relationships, and is also unbalanced in its attribution of policy mistakes and bad management between donors and recipients. The core elements of an alternative diagnosis for policy change, based on the analysis of this Report, can be summarized in seven propositions.

- In spite of problems of implementation and interruptions, and differences among countries, there has been a significant change in the policy environment of many LDCs in the direction of economic liberalization.
- It is correct to argue that it is necessary to have the right national policies for aid to work. However, the policies currently recommended have serious design shortcomings in the context of LDC-type economies. These go beyond their past insufficient attention to social issues. In short, they have neglected the impact of structural constraints, lack of social and economic infrastructure, weakness of market development, the thinness of the entrepreneurial class, and low private sector production capabilities. As a result, the new policy environment does not

deliver high growth rates except when the external trade environment is favourable or reforms are adequately and stably financed. The sustainability of economic growth stemming from these reforms is questionable in most countries.

- Even if the national policy is right, this is not sufficient for aid effectiveness. The lack of coordination among the activities of various aid agencies and the failure to integrate their projects into domestic economic and managerial structures have undermined the sustainability of aid projects. Moreover, although the LDC economies clearly need foreign aid, the fragmented aid delivery system, administered by multiple donors, has profoundly disrupted the resource allocation mechanisms in these countries, with serious negative consequences for economic management, the overall efficiency of resource use, and economic growth in general.
- Aid effectiveness has also been undermined by the external debt burden. This has reduced public and private investment within recipient countries, and also had negative effects on the allocation and use of aid by the international creditor-donor community.
- It is artificial to separate the questions of the quantity and quality of aid disbursements. Increased aid flows will be ineffective without due attention to improvement of aid effectiveness. Similarly, its improvement cannot be divorced from considerations of adequate levels of external finance for the LDCs. Insufficient funding in relation to foreign exchange requirements and the dearth of contingency financing have undermined some structural adjustment programmes, thus contributing to programme interruptions.
- National ownership is vital for development programme success. But weak ownership is not simply a problem of donors bringing inappropriate "off-the-shelf" blueprints which are then imposed by the sticks and carrots of policy conditionality. The poor integration of the aid delivery system into national economic and administrative structures and the lack of coordination of donor activities have, in conjunction with strict policy conditionality on the fiscal budget, eroded government capacities over time, thus undermining the possibility for national ownership.
- Current expectations regarding the implementation of the enhanced HIPC Initiative are unrealistic. The scale of debt relief will prove insufficient to ensure debt sustainability in the medium term unless external conditions are very favourable and economic performance under policy reforms somehow improves; moreover, the magnitude of debt relief, and its manner of delivery, will not have major direct effects on poverty reduction, although it does provide a vehicle for promoting the adoption of pro-poor policies within poor countries.

THE JUSTIFICATION FOR THE ALTERNATIVE VIEW

The justification for this alternative view of the weaknesses of international development cooperation in the 1990s can be summarized under four headings: (i) the mechanisms by which ESAF-financed policy reforms worked in the 1990s; (ii) the relationship between the aid delivery system and aid effectiveness; (iii) the aid-debt service system; and (iv) the adequacy of HIPC debt relief.

The working of ESAF policy reforms in the LDCs

The improvement in the economic growth performance in LDCs undertaking SAF- and ESAF-funded reform programmes in the late 1980s and 1990s was, on average, slight. Focusing on ESAF-programme countries for which data are available, and excluding the extreme positive and negative cases (Equatorial Guinea on the one hand, and Guinea-Bissau, Rwanda, Sierra Leone on the other hand), the average real GDP per capita was declining by 1.4 per cent per annum in the three years before the programmes were initiated, was stagnant in the three years after initiation, and then declined by 1.1 per cent in the next three years. During 1996–1998, real GDP per capita growth picked up to 1.9 per cent per annum, and there has been a further acceleration of export growth and gross domestic investment. However, performance between countries is quite variable, and some countries, such as Uganda, have made notable progress under economic reforms.

The extent to which these outcomes can be attributed to domestic policy changes, the external economic environment, and uncontrollable events such as the weather, is highly controversial. However, rather than embarking on a rather fruitless debate on whether or not economic reforms work by comparing differential outcomes between ESAF and non-ESAF countries, it is now more important to understand the mechanisms through which programmes do, or do not, work, and to assess why programmes have had more positive outcomes in some countries than in others, and at certain times rather than others, and whether positive outcomes are sustainable.

From this perspective, the basic mechanism through which ESAF-funded programmes boost economic growth in LDCs is by increasing their access to concessional financing. As the IMF's own External Evaluation explains, increased concessional finance expands consumption and production possibilities. Typically, the increased supplies of foreign exchange associated with the initiation of an ESAF programme have enabled the rehabilitation and full utilization of existing capital stock rather than the creation of new capital. But expanded official flows in import-strangled economies can also render many more potential investments remunerative, and the cheapening of the price of food and simple consumer goods has often led to the flourishing of informal sector activities.

The positive benefits that follow if the foreign exchange constraint is loosened by increased concessional finance are enhanced by changes in the domestic policy environment. It is extremely difficult to identify the elements of policy reform which contribute most to positive outcomes. However, many observers have concluded that the domestic policy changes which are likely to contribute most are the removal of gross macroeconomic distortions. Structural reforms have not taken sufficient account of structural constraints and institutional weaknesses, and thus the private sector supply response to price incentives has not been as vigorous as expected.

Good results are also associated with favourable changes in the terms-of-trade. For those countries and periods when unfavourable changes in the term-of-trade occurred, it has been difficult to meet fiscal targets, and failure to meet policy commitments could provoke a self-fulfilling collapse to the extent that the resources required to ensure reform effects were either withdrawn or delayed. Contingency measures were not built into programmes, and forecasts of the foreign exchange requirements for adjustment were often over-optimistic. If donor pledges fell short of requirements, financing gaps had to be adjusted in an ad hoc manner according to the ability to mobilize funds rather than on the basis of actual needs. This meant that even though ESAF programmes were in general associated with increased concessional flows, some were underfunded and fated to break down from the outset.

It is also plausible to believe that the working of standard economic reforms is adversely affected by the initial level of external indebtedness. More research is required on this issue. However, if it is the case that once external indebtedness passes a certain threshold reform effectiveness is seriously undermined, a necessary condition if economic reforms are to work in severely indebted countries is *prior* debt reduction. The current policy of making successful adjustment a condition which must be met before debt relief condemns both the adjusting country and the official creditor-donors supporting the adjustment process to considerable frustration. Increased resource inflows in the form of aid and greater national policy effort towards structural adjustment simply cannot move the economy to external viability until there is prior debt reduction.

The aid delivery system and aid effectiveness

The aid delivery system has not been particularly favourable during the era of adjustment and liberalization. In this period government-led coordination withered. Donors were able to coordinate their policy conditionality around IMF and World Bank adjustment programmes. But at the same time, the donor community was, and is, by no means a homogeneous entity, as donors have contrasting experiences and ideas, and these influence the projects and programmes they are willing to support. Thus, relatively strong coordination of policy conditionality has coexisted with great diversity in terms of aid delivery. This tension has played a significant part in reducing aid effectiveness and in disrupting the developmental processes in the LDCs during the past two decades.

Two important empirical findings support this conclusion. First, foreign aid flows are a major source of external shocks for LDCs. For most LDCs, aid flows are actually more volatile than the extremely volatile export revenues, and are also more volatile than current government revenue. In addition, the correlation between the short-term variations of aid and exports and government revenue is weak. It appears, therefore, that foreign aid by and large has not alleviated the effects of short-term external shocks in LDCs, and if anything has reinforced their effects. In short, it is reasonable to conclude that the volatility of aid flows has contributed to increased macroeconomic instability at the very same time that programme aid was seeking to reduce it.

Second, it is apparent that aid has distorted the government finances of many LDCs as they have been subject to the double squeeze of uncoordinated and non-integrated project aid on the one hand, and policy conditionalities to reduce the budget deficit, excluding grants, on the other hand. The effect of this is that capital expenditures as a percentage of total government expenditure have been rising whilst current government expenditure has been falling. The average share of capital expenditure in total government expenditure in LDCs has increased from about 24 per cent during the 1970s to between 32 and 36 per cent in the 1990s. This is in sharp contrast with the average share of capital expenditure in other developing countries, which declined from about 25 per cent to 15 per cent, and it is correlated with the ratio of foreign aid to government expenditure. The high share in the LDCs reflects expenditures associated with aid projects, which are often outside central budgetary processes but nevertheless regarded as public sector investment expenditures. It also indicates the extent to which accumulation in the LDCs is dominated and controlled by multiple donors. At the same time current expenditure is being squeezed. Average current expenditure on education has thus fallen precipitously in LDCs during the adjustment period. The pattern is the mirror image of the growth of capital expenditure and also in contrast with that found in other developing countries, where current government expenditure on education has more or less held steady.

The combination of the aid delivery system and policy conditionality since the early 1980s has particularly undermined economic progress in the LDCs by eroding State capacities. This has occurred through the fiscal effects described above, but also through a domestic brain-drain from the government sector to donor projects and programmes. Foreign aid projects, though nominally in the public sector, have been controlled by the donors, at least until the completion or exit date when the projects are expected to be handed over to the recipient Government. Wages and salaries in the donor projects are usually not set in conformity with public sector pay scales, and in conjunction with the reduction of the public sector wage bill, key personnel have been attracted to the projects, thus eroding administrative capacities. The donors are then increasingly tempted to create parallel management structures for their projects, thus reinforcing the problem. According to most accounts, capacities in most of the LDCs in sub-Saharan Africa are now below the levels of two decades ago. As discussed in *LDCR 1997*, the weakness of the State in many LDCs has become a major impediment to economic progress in these countries.

The aid-debt service system

Aid effectiveness has also been undermined by the external debt burden, which has not only reduced public and private investment in the LDCs, but also adversely affected the aid practices of official creditor-donors. Since the 1980s there has been a close relationship between the geographical allocation of aid flows and debt service payments. For LDCs, throughout the 1990s, the “debt-tail” has been wagging the “aid-dog”, as official creditor-donors as a group have been putting money in where they need to get money out. This aid-debt servicing system has skewed the geographical distribution of aid away from countries without a debt problem, and promoted bilateral aid fatigue. It has subtracted from the volume of aid disbursements available for directly developmental purposes. It has also reduced the quality of aid by increasing uncertainty and pushing aid intensity beyond thresholds where it can be effectively absorbed. The net transfers received by the debtor countries have certainly always been positive, and this has to some extent attenuated the negative effects of debt service payments on foreign exchange availability and public expenditure. But they have also involved immense transaction costs in terms of the time of key economic policy-makers, and debt service obligations have exacerbated the fiscal squeeze. In effect, both international creditor-donors and debtor countries have been caught up in an aid-cum-debt trap, in which high levels of indebtedness undermine aid effectiveness, and low levels of aid effectiveness in turn mean that concessional aid contributes to indebtedness.

The adequacy of HIPC assistance

The HIPC Initiative is targeted at poor countries, rather than LDCs as such. But almost three quarters of all HIPCs (30 out of 41) are currently LDCs, and the HIPC problem is rapidly becoming an exclusively LDC problem. After the end of 2000, if the schedule of implementation set by the international community stays on track, all except two of the HIPCs which have not reached their decision point will be LDCs.

Most observers agree that a necessary condition for the success of the HIPC Initiative is that debt relief should be additional to ODA. The fact that aid flows in the 1990s were closely related to debt service payments makes it likely that a decrease in future concessional finance will accompany reductions in future debt service payments, thus breaching that principle. However, even if this does not occur, the magnitude of additional relief, and the manner of its delivery, mean that it is unlikely to have major direct effects on poverty reduction.

This conclusion follows from examination of the medium-term projections of the few LDCs which have reached their decision point under the enhanced HIPC Initiative. These show, first, that because countries need to take new concessional loans to finance essential physical and social infrastructure the debt overhang can persist for a number of years beyond completion point; but secondly, and more seriously, that forecasts of a durable exit from the debt problem depend on high rates of economic and export growth, sustained over a long period, often over and above rates achieved in the 1990s and accomplished without an increasing import intensity.

It is difficult to see how this will occur. Some might argue that these results can be achieved through enhanced ownership, integration of social policies into policy reforms, and deeper and faster debt relief. But the hypothesis that growth can be accelerated by adding social policies to the standard macroeconomic policies designed to reduce inflation and fiscal deficits, and to the standard structural reforms designed to open economies to the rest of the world and promote privatization and deregulation, is not very convincing. It is difficult to see how poverty reduction strategies will deliver accelerated growth, particularly as they are a new and untested policy mechanism. Moreover, there is a danger that the extension of policy conditionality which stems from linking debt relief and poverty reduction will actually divert attention from the fundamental task of increasing domestic savings and the volume and productivity of investment, and promoting exports. The laudable attempt to increase domestic ownership of reform programmes may easily be undermined through low domestic policy capacities, and a narrow view of acceptable programmes within the endorsement process.

Hopes are being raised that savings on debt service payments through debt relief can make a considerable impact on poverty. But the cash-flow benefits are small relative to net resource flows and aid to the LDC HIPCs. A durable exit from the debt problem depends on accelerating growth, increasing domestic savings and developing productive capacities and international competitiveness. In the absence of these trends, debt relief will bring some short-term poverty relief but no lasting and long-term poverty reduction.

WHAT IS TO BE DONE?

Although for LDCs, and in the particular domain of aid and debt, current moves to reform international development cooperation are founded on a flawed diagnosis of what went wrong in the 1990s, it is wrong to be pessimistic about the future.

There are two reasons for this. First, the international community was focused in the 1990s on the problems of transition economies and the workings of the miracle, and then the crisis, in East Asia. There are signs that attention is now turning away from the national and international policy requisites of developmental catch-up, a subject on which much has been learned from East Asian industrialization, towards the question of how to promote a sustainable take-off in the poorest countries in the world economy. Second, there is now a window of opportunity in which the approach to international development cooperation is in flux. There appears to be more open debate of the issues, and also a commitment to adaptive learning on the basis of experience and the incorporation of the diverse perspectives of the different stakeholders.

The present analysis provides a strategic perspective on the problem of financing development in the LDCs which suggests five key axes of change:

- Reorienting national policies;
- Ensuring adequate aid flows;
- Implementing partnership based on genuine national ownership;
- Undertaking adequate debt relief;
- Increasing systemic policy coherence.

Re-orienting national policies

Analysis of successful development experiences shows that sustained and accelerated economic growth is built on the development of productive capacities and international competitiveness, and on a structural transformation away from a narrowly specialized primary commodity economy. Success depends on establishing a virtuous circle between investment, exports and savings. In this process exports support investment because they earn foreign exchange required for the import of goods and technology needed for capital accumulation and growth, while investment supports exports by providing the basis for technological change, productivity growth, increased competitiveness and structural change. As incomes and profits are increased through investment, they increasingly provide additional resources for capital accumulation. Poverty reduction occurs as an integral part of the circle of cumulative causation if employment opportunities expand rapidly, although the poverty-reducing effects of growth are less in high-inequality countries than in low-inequality countries. Policy efforts are required in order to strengthen these effects by ensuring wide access to productive assets and by creating linkages which incorporate marginal sectors into the space of productivity growth.

It is well understood now that a sustained process of economic growth and poverty reduction is best realized by giving a greater role to market forces and private initiative. However, leaving growth to market forces without adequate attention to the shortcomings of markets, institutions and infrastructure in LDCs is not going to do the trick. A pragmatic approach to the design of structural reforms is thus required.

Such an approach would seek to promote a virtuous circle between the growth of exports, investment and savings through a better balance between public action and private initiative than that currently recommended. This certainly does not mean a rush back to public ownership and isolationism. However, beneficial and sustained integration into the world economy will be best achieved if growth-oriented macroeconomic policies are complemented by specific meso policies designed to increase productivity and competitiveness at the enterprise level and to improve the enabling environment for enterprise. The design of these measures should take advantage of the policy leeway which countries at low levels of development have, by right, within international trade regimes. Where appropriate, the measures should also adopt a regional or subregional approach.

Ensuring adequate aid flows

Whatever domestic policies are undertaken, they are unlikely to be effective unless they are supported by adequate external finance. There is no straightforward answer to how much external finance is required. Indeed, this type of question is best posed within an individual country context. Nevertheless, with prevailing savings propensities and investment efficiency, it has been estimated that external resources must be more than doubled for sub-Saharan Africa on average to achieve the goal of reducing the incidence of poverty by half by 2015. Moreover, UNCTAD’s own estimates of external resource requirements for sub-Saharan Africa to achieve growth rates of 6 per cent per annum are between 50 to 150 per cent higher than the existing flows in the short run. Such average projections are likely to be relevant to most African and Asian LDCs which are caught in a vicious circle in which low incomes and slow growth are both a cause and a consequence of low domestic savings, low rates of investment and low efficiency of resource use.

Private capital flows can play a role in meeting some of these needs. Indeed, increasing the inflows of forms of private capital which support the longer-term development goals of export growth, technology transfer and employment creation should be a central objective of both the LDCs and their development partners. But policy makers in the LDCs should not have false expectations that FDI can lead the development process, and donors should not see the signs of rising private capital inflows into a number of LDCs as an opportunity for reducing ODA. For the immediate future, given the constraints on private capital inflows, most LDCs must rely on ODA as their major source of external finance.

A reduction in development aid by the donor community, on the assumption that all developing countries now find themselves in an era of global private capital flows, is not likely to lead to the substitution of FDI and commercial bank loans through established channels for aid. Rather, it is more likely to promote the substitution of private current transfers from international migrant workers for aid. More LDCs will also become increasingly integrated into an international informal economy in which largely unrecorded private capital flows support “grey” economic activities such as the smuggling of gems, illegal logging and narcotics, and the donor community will face increasing financial outlays for peacekeeping and humanitarian emergencies.

Implementing partnership and genuine national ownership

Increased aid flows will not have positive developmental effects unless efforts are made by both the LDCs and their development partners to enhance aid effectiveness. The implementation of partnership based on genuine national ownership is vital for development programme success. As efforts are now made to let the aid recipients take the lead in both policy formulation and implementation, it is important for the IMF and World Bank to manage the inevitable tension between policy conditionality and domestic ownership in a way which accepts a pragmatic view of the key policy ingredients for accelerating growth and reducing poverty. Real partnership must allow for differences in perspectives and provide room for partners to learn from mistakes. A pluralistic conception of development strategies, which is not wedded to a single model, should be encouraged. It would be easy for selectivity, which functions as a threat of withdrawal of concessional finance if the policies are not right, to act as a mechanism which guides policies to those which fit the donors’ preferences. This does not mean that donors should not be selective with respect to which countries to support. But they should guard against selectivity working as arm’s-length policy conditionality. This is most likely to be achieved if the monitoring of outcomes and the setting of performance criteria are based on independent research which takes account of the constraints and institutional specificities of recipient countries, and the recipient countries have a greater voice in the formulation of the policy agenda and the monitoring of outcomes.

Besides the acceptance of different development approaches, three basic requirements have to be fulfilled for genuine policy ownership to become a reality in the LDCs. First, there must be a serious effort by the countries themselves to establish comprehensive and coherent budgets and medium-term expenditure plans which have the required transparency, accountability and realism to be taken seriously by the donors and their own domestic constituencies. Second, the donors need to provide the necessary information about their current activities and future plans to make the first task possible. They should be also prepared to coordinate their procedures with the local requirements and integrate their activities within the national budgets and expenditure plans – in other words, genuinely to put the recipient country in the “driver’s seat”. Third, a realistic assessment of the immediate financial requirements to jump-start the process needs to be made, and the necessary funds need to be made available in order to get the countries out of the downward spiral of erosion of State capabilities. A fundamental prerequisite of recipient country ownership is to reinstate the lost capacities of the States, which is a particularly demanding task in the Sub-Saharan African LDCs.

Realizing the first requirement for genuine policy ownership depends firstly on adequate human resources. One important technical capacity for effective policy which requires strengthening in many LDCs, particularly in sub-Saharan Africa, is financial auditing and accounting. This is the backbone of government accountability and a basic precondition for genuine policy ownership. The political processes underlying the formulation and implementation of the budgets are, however, at least as important as the financial and accounting technicalities. Due consultation with all the relevant line ministries, and open discussion by relevant stakeholders of the strategic development visions and the means to implement them, are essential preconditions for transparency, accountability and credibility of government efforts, which in turn are necessary to convince the donors to integrate the financial management of their projects and programmes within the government budget.

However, without simultaneous support by the donors, and without an effort by them to coordinate their aid with each other and with the domestic economic processes, the efforts by the recipient Governments in aid-dependent economies are likely to remain ineffective. This is the second precondition for genuine policy ownership. The internal processes of consultation, transparency and consensus building around the budget would be rendered futile without timely and accurate financial information from the donors. The lack of synchronization of donors' and recipients' budget cycles, the use of different accounting conventions and classifications, provision of incomplete data on aid disbursement, and lack of information on aid strategies and future expenditure plans by the donors, are well-known deficiencies of the aid delivery system, which have made the task of financial management in the recipient countries difficult, if not impossible. However, the most important impediment to comprehensive medium-term public sector expenditure planning and financial management in the LDCs, is that a large part of the donor-funded projects and programmes indeed bypass the central government budget.

An important precondition for the much-discussed public sector reform in the LDCs is a more cooperative and trustful attitude by the donors. Along with reforming public sector pay structures, the donors need to end their prevalent practice of parallel staffing and remuneration arrangements on stand-alone projects. Donor funds should increasingly take the form of budget support or collaborative sector-wide programmes administered by recipient Governments in accordance with objectives and priorities agreed with the contributing donors. New forms of aid which bypass the budgetary and monitoring scrutiny of reformed government administration, and are uncoordinated with national priorities, need to be restrained. The basic elements for the establishment of good partnership have been, of course, emphasized for a long time in various OECD manuals on effective aid. Although recent enthusiasm for recipient country ownership may hasten the reform in the aid delivery system, this process of change is likely to take some time. The pace of reform may be helped by closer monitoring of aid, with indicators selected in terms of benefits to recipients rather than costs to donors.

This extended agenda, apart from making a more focused and efficient use of the financial and human resources in the public sector essential, also implies the need for additional aid in order to relax the financial bind on the Governments. This is the third requirement for effective domestic policy ownership. It should not be regarded as aid-funded current government consumption with an open-ended outlook, but rather as an initial investment which is necessary for creating a more trim and efficient, and better remunerated and motivated civil service. This is necessary for the success of other reform programmes which in due time would lead to increased government revenues and the gradual end of aid dependence.

Undertaking adequate debt relief

There is a need for deeper, faster and broader debt relief which is based on lower thresholds for judging debt sustainability, more realistic forecasts of economic growth, exports and imports, and more upfront extinction of the debt stocks and the front-loading of debt service relief. The major obstacle to this is how debt relief can be financed. The degree of enhancement which occurred with the shift from HIPC I to HIPC II was constrained by the need to ensure that additional costs could be met, and even now it is proving difficult to ensure that HIPC II is adequately financed. It is therefore imperative that international policy efforts focus clearly on the financing bottleneck in debt relief for LDC HIPCs. Costing of debt reduction needs to be made in a way which takes account of the risk of non-payment. Assessment of the real financing costs of debt relief to creditors should also take account of the benefits of removing the debt overhang from official creditor-donors. This is a necessary condition for enhanced aid effectiveness.

Policies to address the external debt problem which is affecting many LDCs should also be re-examined in the light of their effects on private capital flows. There is clear evidence that the debt burden is having detrimental effects on private capital inflows, and policies of debt relief should be geared to improve private sector expectations. If successful, this will support long-run poverty reduction.

Enhanced systemic policy coherence

There is a great potential for increasing the positive synergies between international policies towards LDCs in the domains of aid, debt reduction, international trade and the promotion of private capital flows. At present, policy discussion in each of these domains too often takes place in separate compartments and so not only are potential positive synergies missed, but support measures in different domains can be mutually antogonistic. It is clear that the debt overhang on official creditor-donors is undermining aid effectiveness, and that economic reforms work better when the international trading environment is favourable for the LDCs. Steps should be taken to reduce any negative synergies which exist between the current approach to the external debt problem and trade development and the promotion of private capital inflows, as well as between the international trade regime and aid effectiveness. Market access and remunerative commodity prices remain as vital as ever for the LDCs, and it is important that the rethinking of international development cooperation, which has moved so rapidly in the last three years in the areas of aid and debt policies, incorporates the trade dimension. It is through international trade that the LDCs will make their way in the world.

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As the LDCs and their development partners work towards UNLDC III at Brussels in May 2001, they need to keep in mind alternative future scenarios for the LDCs. At one extreme, most LDCs will remain trapped at a low level of economic development. They will be pockets of persistent poverty in the global economy, falling behind other developing countries and obliged to call on the international community for aid to tackle humanitarian crises and peace-keeping missions. They will also be epicentres for the global refugee population and major sources of international migrant workers. At the other extreme, it is possible to envisage a progressive transition in which dependence on development aid is reduced as growth is sustained more and more by domestic resource mobilization, the attraction of FDI and the tapping of international financial markets, and productive capacities and internationally competitive activities develop as a result.

In the end it is for UNLDC III to decide on the most appropriate national and international measures for the coming decade and the elements of a new partnership. But it is vital for it to make its decisions on the basis of a realistic diagnosis of what has happened in the recent past. It will then be possible to achieve better results this time.

There is a choice.

Rubens Ricupero

Secretary-General of UNCTAD