



# THE LEAST DEVELOPED COUNTRIES REPORT 2014

## *Growth with structural transformation: A post-2015 development agenda*

### OVERVIEW



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A Post-2015 Development Agenda*

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UNITED NATIONS  
New York and Geneva, 2014

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The Overview contained herein is also issued as part of *The Least Developed Countries Report 2014* (UNCTAD/LDC/2014), sales no. E.14.II.D.7).

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UNCTAD/LDC/2014 (Overview)

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# Introduction

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At the beginning of the millennium the least developed countries (LDCs) enjoyed the strongest and longest growth rates since the 1970s, benefiting from sustained global growth, surging commodity prices and buoyant capital flows. Between 2000 and 2008, the average annual growth of the group's real gross domestic product (GDP) exceeded 7 per cent, raising hopes that some LDCs may be able to graduate from this category within the present decade. However, since the outbreak of the global financial crisis in 2008 and the drastic change in external conditions, LDCs have experienced a slowdown of economic activity. As a result, their economic growth has been much weaker during the past five years and well below the target rate of 7 per cent annual growth established in the Istanbul Programme of Action (IPoA), and considered necessary for attaining the Millennium Development Goals (MDGs).

Further progress in human development can only be made by reigniting sustained economic growth in the LDCs and accelerating the structural transformation of their economies. This means changing the composition of output and employment towards those economic sectors and activities with higher productivity and value added. Indeed, it is only if efficiency gains and changes in the structure of their economies happen concomitantly, that they will be able to achieve economic progress on a sustainable basis, and improve the living conditions of the most vulnerable people. History has shown that sustained economic growth and development are achieved by those countries that are able to effectively transform their productive activities from low to high productivity, and diversify their production and exports.

*The Least Developed Countries Report 2014* examines the linkages between structural transformation, economic growth and human development. It argues that LDCs cannot, and should not, focus only on aggregate growth; they also need to pay attention to the type of growth pattern and its main drivers. The Report also considers what LDCs can do to transform their economies in order to foster economic growth and achieve the MDGs and the Sustainable Development Goals (SDGs) which are planned to succeed them, and what the international community can do to support LDCs in their structural transformation and in their efforts to achieve the SDGs.

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## Recent trends and outlook for the LDCs

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With the recovery of the global economy remaining slow and uneven, the LDCs faced a challenging external environment in 2013. Sluggish global economic growth, which translated into weaker international demand for commodities and a consequent decline in their prices, adversely affected the economic growth and export performance of several LDCs. Inflows of foreign direct investment (FDI) reached a record high and remittance inflows continued unabated, but official development assistance (ODA) started to show signs of stagnation. Most notably, the external environment in 2013 differed considerably from the highly favourable one of 2002–2008 when LDCs displayed an impressive economic performance.

Despite the less favourable external environment, the group of LDC economies attained an average real GDP growth rate of 5.6 per cent in 2013. This is higher than the average growth rates of developed countries (1.2 per cent) and all developing countries (4.6 per cent), but below the upward revised rate of 2012 (7.5 per cent) and the average rate of more than 7 per cent reached during the boom period of 2002–2008. Moreover, their much faster demographic expansion offset comparatively faster GDP growth. Thus, real GDP per capita in LDCs as a group increased by 2.8 per cent in 2013, which means that many LDCs' per capita income growth was higher than their population growth by only a small margin, and will therefore have had only a limited impact on living standards in a context of widespread poverty.

While LDCs in all regions attained similar growth rates (hovering at around 6 per cent), their economic performance based on their export specialization showed mixed trends. In 2013, exporters of food and agricultural products as well as exporters of minerals saw improvements in economic performance. Conversely, growth in fuel exporters, mixed exporters, services exporters and exporters of manufactures slowed down, albeit at different rates. Fuel exporters' growth rate in 2013 (4.7 per cent) was substantially lower than that of the previous year (10.3 per cent). This slowdown was caused by a notable decline in fuel revenues in Angola, Chad and Equatorial Guinea, where the fuel sector was adversely affected not only by lower fuel production but also by lower international prices for crude oil.

In 2013, the current account and merchandise trade of the LDCs as a group were weaker. Their current account deficit continued to rise, reaching

a historic peak of \$40 billion in 2013, and their merchandise trade deficit also widened, escalating by 29 per cent to \$21.1 billion. Still, this was significantly smaller than the 338 per cent increase in the trade deficit in 2012, when exports declined in line with the worldwide deceleration of trade in goods. However, there were notable differences in the merchandise trade balance of the different LDC geographical groups. The sharp shrinking of the merchandise trade surplus of African LDCs and Haiti contributed largely to the widening of the LDCs' negative balance. Island LDCs' merchandise trade deficit increased by 22 per cent, to reach a historic \$1.6 billion in 2013. Asian LDCs, on the other hand, reduced their merchandise trade deficit by 3.2 per cent, to \$23.4 billion, largely thanks to increases in the exports of labour-intensive manufactures from Bangladesh and Cambodia.

LDCs' capital inflows increased, but their external resource gap continued to widen in 2012. The increase in capital inflows was driven by higher private inflows in the form of both remittances and FDI, whereas ODA flows, the largest source of external financing for LDCs, showed signs of stagnation. For two consecutive years (2011 and 2012), the average annual growth rate of ODA flows was only about 1 per cent, partly due to a broader set of austerity measures adopted by the developed-country donors in recent years. In addition, lower savings rates in LDCs led to a widening of the external resource gap, which increased their need for external finance — a long-standing requirement of LDCs, which continues to play a vital role in financing investment.

Against this background, the outlook for the LDCs in the short and medium term remains uncertain. While global output is expected to strengthen moderately in the medium term, uncertainty about the pace and the strength of the recovery persists. A fragile and uncertain global recovery could hinder LDCs' economic performance due to weak international demand and lower commodity prices. Adjusting to a changing external environment has always been a key challenge for these economies, but this is now exacerbated by a subdued world economy and prevailing uncertainties.

The less favourable external environment, coupled with LDCs' weaker growth performance, suggests that achieving the MDGs, or the SDGs that are planned to succeed them, is likely to be extremely challenging. Indeed, a more strategic approach will be necessary to bring about the structural transformation necessary for sustained and inclusive economic growth.

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## LDCs' progress towards achieving the MDGs

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The MDGs have embodied the development objectives of the global community since 2000. They focus on the reduction of extreme poverty and hunger, improvements in basic standards of human development (in terms of education, gender equity, health, and access to water and sanitation), environmental sustainability and raising the level of international support to development. The end of the MDG cycle in 2015 therefore offers an important opportunity to analyse the progress of the LDCs towards achieving the MDGs, and to assess the effectiveness of the policies implemented so far. It is crucial to learn major lessons from this experience so as to inform future policymaking and increase the chances of achieving the much more ambitious SDGs associated with the post-2015 development agenda, which will shape the development debate over the next 15 years.

MDG 1 aims at halving extreme poverty and hunger. On average, LDCs reduced poverty (based on the \$1.25-a-day poverty line) from 65 per cent of the population in 1990 to 45 per cent in 2010. In percentage points, this is as fast as the reduction in other developing countries (ODCs) – from 40 per cent to 20 per cent. However, it is substantially slower in relative terms (less than one third compared with half), and insufficient to halve poverty by 2015. The Asian LDCs have progressed much faster than the African ones and Haiti, and are broadly on course to halve poverty. The general failure of non-Asian LDCs to achieve MDG 1 largely reflects their inability to translate historically rapid economic growth into corresponding increases in decent employment and to advance the process of structural transformation.

The average prevalence of undernourishment in LDCs has shrunk at a slower rate than poverty, from 36 per cent of the population in 1990–1995 to 29 per cent in 2010–2012, a reduction of about a quarter. This is slightly smaller, proportionally, than the average for ODCs, and substantially less than what is needed to halve hunger by 2015. The level of undernourishment in African LDCs and Haiti is higher than in Asian LDCs, and has also fallen more slowly. However, even the latter are not on course to halve undernourishment by 2030.

MDG 2 refers to universal primary education, and aims to “ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling”. The average primary enrolment ratio for LDCs

has increased by half since 1990, rising from 50 per cent to 75 per cent. There has been a strong increase in net primary enrolment both in African LDCs and Haiti (from 46 per cent to 71 per cent of the population at the relevant age group) and in Asian LDCs (from 60 per cent to 94 per cent). In terms of gender disparities, while the gender balance at all levels of education has improved considerably in LDCs since 1990, the 2005 targets were not met, on average, and the gender gap remains very wide at the secondary and, especially, the tertiary level.

The LDCs have made substantial progress with respect to child survival and maternal health (MDGs 4 and 5). The average under-five mortality rate has fallen by almost half, from 156 per 1,000 live births in 1990–1995 to 83 per 1,000 in 2011–2012, with a somewhat faster rate of improvement in Asian than in African LDCs and Haiti, and the island LDCs. The average maternal mortality ratio per 100,000 live births has shrunk by nearly half in LDCs as a group, from 792 in 1990 to 429 in 2010, but it falls short of the rate of reduction required for achieving the goal. These improvements partly reflect better maternal and child nutrition, as well as more effective vaccination and maternal and child health programmes.

MDG 6 envisages reversing the spread of the human immunodeficiency virus infection/acquired immunodeficiency syndrome (HIV/AIDS) by 2015, and ensuring access to antiretroviral therapy (ART) for all those who need it by 2010. There has been a noticeable decline in HIV/AIDS prevalence in LDCs since 2000, as in the developing world as a whole, reflecting improvements in access to treatment, nutrition, medical practices and condom use. However, despite improvements in recent years, the goal of universal access to ART is far from being achieved, even beyond the target date of 2010. The deficiencies of LDCs' health systems have been sharply highlighted by the spread of the Ebola virus in West Africa in 2014, which could jeopardize, or even reverse, the achievements of several LDCs in the region in terms of human and economic development.

Similarly, progress in access to safe drinking water and basic sanitation (MDG 7) is well below what is needed to meet the goals. Average access to an improved water source increased in LDCs from 54 per cent of the population in 1990–1995 to 69 per cent in 2011–2012. However, this again falls short of the rate of improvement required to halve the proportion of the population that lacks access by 2015, which would require an increase to 81 per cent. Still, Asian LDCs have performed substantially better than the average, and



are close to achieving the goal. Average access to sanitation increased from 22 per cent in 1990 to 36 per cent in 2012, less than half the average for ODCs (76 per cent). Again, the Asian LDCs have performed better than other LDCs, nearly tripling access, but even they are likely to fall short of the goal.

Overall, by any historical standard, the achievements of the LDCs since 1990 in the areas highlighted by the MDGs have been quite remarkable. Nevertheless, only one LDC (the Lao People's Democratic Republic) is on track to meet all of the seven MDG targets assessed in *The Least Developed Countries Report 2014*. This is partly a reflection of limited progress on MDG 8, which seeks to create a “global partnership for development”. Major donors have fallen short of their commitments on ODA; LDCs' debt problems have not been dealt with comprehensively, leaving several in, or at risk of, debt distress; LDCs' trade preferences relative to ODCs have been seriously eroded; and the global economic and financial architecture has proved unable to prevent major global financial, food and fuel crises since the turn of the century.

There are significant differences among the various LDC groups in their degrees of achievement of the MDGs. While several Asian LDCs are on track to meet most of the goals, progress has been much slower in the majority of African LDCs and Haiti as well as the island LDCs, which means they will not meet most of the MDGs. This largely mirrors relative performance in structural transformation. Typically, Asian LDCs have succeeded in changing the production structures of their economies to a large extent, transferring labour to higher productivity activities over the past 20 years. Other LDCs, by contrast, have made little progress in this regard, and in some cases there have even been setbacks. Thus, the varying degrees of success in attaining MDGs across LDCs seem to be associated with their different economic dynamics over the past two decades. To gain a better understanding of the reasons why some LDCs have performed better vis-à-vis the MDGs, it is necessary to analyse the patterns of structural transformation and labour productivity growth in LDCs, bearing in mind the necessary synergies between economic and human development.

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## **From MDGs to SDGs: Reconnecting economic and human development**

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The year 2015 marks a turning point for development policies: from a period when development efforts focused on the MDGs, to a post-2015 development agenda which will be encapsulated in a broader – and much more ambitious – set of Sustainable Development Goals (SDGs) to be achieved by 2030.

Human development and economic development are inextricably linked. Human development, broadly defined, is the primary objective of economic development. At the same time, economic development is an essential means to human development. Thus economic and human development can most effectively be met by pursuing both sets of goals together through policies that strike a balance between the two, and which take full account of their direct and indirect effects on both dimensions. This was a major failing of economic policies that focused mainly on controlling inflation and reducing external imbalances in the 1980s and 1990s. Equally, however, pursuing human development goals without addressing the underlying economic causes will at best result in progress that is unsustainable, and may even be counterproductive in the long term. Poverty, undernourishment, poor health and low educational attainment are in fact part of a vicious circle which plays a key role in preventing LDCs from progressing socially and economically. All these social problems pose serious obstacles to productive investment, and ultimately hinder economic development. Poor economic performance in turn limits the capacity for poverty reduction and the resources needed for promoting health and education, thus creating a pernicious vicious circle.

Breaking this vicious circle, and turning it into a virtuous one, requires sustained increases in labour productivity, which, coupled with job creation, is essential for long-run economic growth. This allows a continuous rise in real labour incomes necessary for poverty reduction and human development. The only way to achieve this is through structural transformation, whereby resources are shifted from less to more productive activities and the economy is able to generate continually new dynamic activities characterized by higher productivity. Such transformation is essential in the context of the planned SDGs. Only a few LDCs have undergone any significant economic transformation since 1990, and it is largely this failure which underlies their generally weak performance in meeting the MDG targets.

Given that the proposed SDGs are even more ambitious than the MDGs, their attainment will be all the more challenging. This is compounded by the present uncertain external environment, with the global economy continuing to struggle in the wake of the financial crisis. Therefore, meeting the new goals will require nothing short of a revolution in LDCs' economic performance. More specifically, it will necessitate their structural transformation on a scale unprecedented for these countries.

Achieving the SDGs will also require considerable increases in the incomes of the poorest. In 2010, the average income of the poorest 5 per cent of the population in LDCs as a whole was about \$0.25 per day. Raising this average to \$1.25 per day by 2030 would require a fivefold increase; that is, an average annual per capita income growth rate of 8.3 per cent. This is more than three times the rate achieved even in the favourable economic climate of 2002–2010 (2.7 per cent per year), and 20 times that achieved over the previous two decades (0.4 per cent per year). Even this would still leave some 2–3 per cent of the population dependent on income transfers to escape extreme poverty.

In some LDCs, the incomes of the poorest segments of the population are much higher, and the challenge may be more manageable. Bhutan has already reduced the proportion of those living in poverty (at the \$1.25-a-day line) to below 5 per cent. Five other LDCs (Cambodia, Djibouti, Sao Tome and Principe, Sudan and Yemen) had poverty rates of between 13 and 20 per cent. At the other end of the scale, however, five LDCs (Burundi, the Democratic Republic of the Congo, Liberia, Madagascar and Zambia) had poverty rates between 75 per cent and 85 per cent in 2010. Overall, the average income of the poorest 5 per cent in these countries is just \$0.13 per day, requiring an annual growth rate of 15 per cent to reach \$1.25 per day by 2030. Thus they face a formidable challenge.

What is needed is not merely to increase overall productivity, but also to create productive and remunerative employment (and self-employment) opportunities for the whole workforce, with sufficiently high productivity to sustain incomes above the poverty line. This means increasing demand faster than the increase in labour productivity. If labour productivity is increased without (domestic and foreign) demand growing at least as fast, either employment will decline or workers will be pushed out of the sectors of rising productivity into the lower productivity “refuge” sectors of informality and family agriculture. Either way, poverty will rise instead of falling.

Neither the neoliberal market approach nor the more interventionist East Asian model based on export-oriented manufacturing seems likely to achieve employment for all with high enough productivity. In both Latin America and sub-Saharan Africa, the neoliberal model increased efficiency in manufacturing primarily by driving relatively inefficient producers out of business, while those that survived shed labour. While this increased labour productivity in manufacturing, total employment in the sector fell. The result was a process of reverse structural transformation in which labour moved from the manufacturing sector into lower productivity sectors, notably the informal sector.

The East Asian model is more conducive to structural transformation to the extent that it promotes employment in manufacturing. However, this alone is clearly insufficient to eradicate poverty in 15 years in most LDCs. The peak level of employment in manufacturing has declined in successive generations of industrializing countries, from above 30 per cent in Germany and the United Kingdom to the mid-teens in several Latin American and Asian economies which have begun a process of premature deindustrialization. This falls far short of the increase in higher wage employment required for poverty eradication in most LDCs.

This analysis suggests that employment in manufacturing alone is not enough to generate sufficient well-paid jobs to achieve poverty eradication; boosting productivity and incomes in other sectors, especially agriculture and services, will also be essential. Agriculture, in particular, is critical for reducing poverty in LDCs. The majority of people in LDCs live in rural areas, with a handful of exceptions (Djibouti, Sao Tome and Principe, Angola, the Gambia, Haiti and Tuvalu, where 36–49 per cent live in rural areas). In 20 countries — including three of the five exporters of manufactures — the share of the rural population is 70–90 per cent. Across LDCs in all developing regions, poverty also tends to be greater in rural areas than in urban areas, even allowing for differences in living costs, although this tendency appears to have diminished over time.

In the great majority of LDCs, the additional income required for poverty eradication is thus needed the most by people in rural areas. Even with unlimited employment growth in urban areas, the potential for poverty eradication through industrial development alone would be limited by social and environmental considerations concerning the pace of urbanization. Moreover, the potential to increase agricultural productivity without a major

reduction in employment is constrained by the substantial labour surplus in small-scale agriculture in most LDCs. This suggests that the diversification of rural economies into non-agricultural activities and the generation of non-farm income sources in rural areas will need to be key objectives. Even in established exporters of manufactured goods, this is likely to be a necessary adjunct to further industrialization if poverty is to be eradicated by 2030.

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## **Structural transformation and labour productivity in the LDCs**

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Economic development is a long and challenging process involving progressive increases in labour productivity, along with large-scale changes in the structure of the economy, as new and leading sectors emerge as drivers of employment creation and/or technological upgrading. In the short run, either of these mechanisms, even in isolation, may drive growth. However, economic development can be sustainable in the medium to long term only if productivity improvements and changes in the structure of the economy advance hand in hand.

Increases in labour productivity are necessary to sustain the income and wage growth required to pursue the desired development goals. Labour productivity growth also creates the conditions for structural transformation to take place by increasing value addition asymmetrically across sectors. Structural transformation, in turn, by transferring resources towards the more productive sectors, contributes to overall productivity growth. Without structural transformation, therefore, a significant proportion of potential productivity gains would remain unexploited. Equally, without the trigger of labour productivity dynamics, structural transformation would be seriously hindered.

Output per capita over the period 1991–2012 grew at an average annual rate of only 2.6 per cent in the LDCs, though with considerable variations among them. Mixed exporters and exporters of manufactures (the latter dominated by Asian LDCs) performed better than the average, growing at an average annual rate of 3.3 per cent. The second set of groups which grew more slowly — at annual rates between 1.9 per cent and 2.7 per cent — consists of fuel and services exporters. Finally, in the exporters of minerals, and food and agricultural products, output per capita was either stagnant or

declined over the period. All economies in these two groups of exporters are African, with the exception of the Solomon Islands. Overall, the economic performance of the African LDCs — as reflected in their output per capita — lagged behind the LDCs in the other regions.

Measuring structural transformation by the changes in the sectoral shares of employment shows that the mostly Asian producers of manufactured goods recorded the fastest rate of transformation, with a 16.2 percentage point decline in the agricultural sector's share of employment. This group of LDCs was followed by services exporters and mixed exporters, where the agriculture share of employment declined by 10 percentage points and 9 percentage points respectively. At the opposite end were exporters of food and agricultural goods, and of minerals — both dominated by African LDCs — where there has been little or no structural transformation of employment.

Variations in growth rates of labour productivity across groups are closely associated with the dynamics of their economic structures. African LDCs and Haiti have trailed the other LDC regional groups, with labour productivity expanding at an average annual rate of 1.6 per cent during the period 1991–2012. This was half the annual rate of growth recorded by the Asian LDCs. A different pattern emerges for the island LDCs, where labour productivity declined in relative terms until 2003, when the trend reversed sharply upwards. The impressive recent economic performance in this LDC group has been largely due to an increase in the exploitation of oil and gas resources in Timor-Leste, which pushed the group's average annual growth rate to 5.8 per cent.

The challenges faced by the LDCs to raise labour productivity become even more evident when they are grouped according to their export specialization. The best performers have been exporters of manufactured and mixed goods. Although they began the 1990s with a decline in labour productivity relative to the ODCs, they have managed to stabilize the situation since then, and to achieve an average annual growth rate in output per worker of 2.9 per cent. The LDC performers that have lagged furthest behind are exporters of food and agricultural products, and mineral exporters. Labour productivity in the former group declined in absolute terms at an average annual rate of about 0.8 per cent during the period 1991–2012, and it stagnated in mineral exporters.

Overall, rapidly growing LDCs have experienced both significant labour productivity growth and major structural changes in employment shares

across all sectors: agriculture, industry and services. During the period 1991–2012, countries with an average annual rate of growth of 3 per cent or more experienced faster productivity growth within sectors and more profound changes in sectoral shares of employment. These were mainly exporters of manufactured goods. Moreover, among LDCs, only this group surpassed ODCs’ record on the share of aggregate productivity gains driven by the sectoral reallocation of labour.

Structural change and sustained increases in labour productivity are therefore closely related to income growth, which in turn is required to pursue development goals. This double nexus partly explains why there is a strong and positive association between the degree of completion of MDGs and the extent of structural transformation across LDC economies. However, structural transformation can also facilitate attainment of the MDGs independently of its impact on per capita income. For a given level of income growth, higher wages related to increases in productivity might facilitate poverty eradication and progress on the remaining MDGs. Likewise, a shift of resources from the natural resources sector to manufacturing, for example, is likely to lead to the creation of new jobs even if total production remains unchanged. Accordingly, The Least Developed Countries Report 2014 finds that, for several MDGs, the correlation between growth and the MDG completion rate was much higher in those countries that accomplished relatively faster structural transformation than in the economies that lagged behind in such transformation. In the latter case, the impact of income growth on human development was close to zero.

Only in a few LDCs has economic growth been associated with structural transformation, sustained increases in labour productivity and decisive progress towards the MDGs. Most LDCs experienced strong economic growth in the 2000s, but little structural transformation. This divergence warrants closer examination, including investigating the experience of those non-LDC developing countries that have been even more successful in creating a virtuous circle between structural transformation, productivity growth and human development in recent decades. This has enabled them to set in motion a lasting development process, and thereby perform well against the MDGs. The policies they have adopted may provide important lessons for the LDCs as they strive to meet the new development goals in the post-2015 context. It is of crucial importance for LDCs to develop a policy framework that is able to foster labour productivity growth and facilitate the progressive shift of resources towards more productive sectors in their development process.

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## **Structural transformation, labour productivity and development policies in selected non-LDC developing countries**

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The Least Developed Countries Report 2014 considers what lessons LDCs may be able to draw from the growth experiences of four successful non-LDC developing countries: Chile, China, Mauritius and Viet Nam. These countries have been selected partly because of their success in achieving most of the MDGs within a short period of time as a result of their rapid economic and social development, and partly because they are representative of a wide range of conditions and circumstances, including size, geographical location, politics, history and demographics. The range of their GDP per capita at the initial stages of their respective economic reforms is similar to the range of GDP per capita in LDCs in 2013. They are from three developing regions, range in population from 1.3 million in Mauritius to 1.3 billion in China, and have very different political, cultural and historical backgrounds and social structures. Their production structures also vary widely: China has established itself as the manufacturing workshop of the world, Chile's economy remains strongly dependent on resource-based commodities, while Mauritius and Viet Nam have a mix of the two.

Lessons from past development experiences of countries must be interpreted with considerable caution when drawing from them to inform strategies in other countries. Grasping dynamic country experiences involves analytical risks, and can be prone to reinterpretation over time due to an imperfect understanding of the drivers of growth and development. However, it would be equally imprudent to assume that no insights or lessons can be gleaned from successful cases. Broad lessons from experiences relate primarily to the “demonstration effect” of the ways in which structural transformation can be achieved, and the broad types of policy instruments and strategies, institutional arrangements and innovations that contribute to this process. The general contours of structural transformation are easy enough to identify, ex post, but the finer details and specific policy prescriptions must necessarily be firmly based on ex ante circumstances of individual countries.

Above all, structural transformation requires policies that encourage investment in a range of higher productivity sectors and activities and in increasing the productivity of existing production, both of which involve



different types of innovation. While there is a wide range of policy instruments for these purposes, based on the four country cases, three broad and interrelated areas of domestic policy are highlighted, which are critical for sustaining the economic transformation process. The first policy area is resource mobilization by both the public and private sectors. This refers to instruments to raise and mobilize the resources needed for investment in productive activities, including the economic and social infrastructure. The financial and banking systems are crucial in determining how resources are mobilized and allocated, and they can alter the room for manoeuvre in the second policy area. The second area concerns industrial and sectoral policies, through which policymakers promote the development of specific economic activities or economic agents (or a group thereof) based on national development priorities. They encompass both horizontal policies (applied across all sectors, e.g. to address economy-wide market imperfections and externalities) and vertical policies (applied only to selective sectors or activities), although there is a fair degree of overlap and complementarity between the two.

Third, successful structural transformation requires appropriate macroeconomic policies. While macroeconomic policies are typically seen as focusing on the short-term management of aggregate variables, they also have long-term impacts that may be critical to successful structural transformation. Of particular importance are their effects on public investment, the availability and cost of credit and the real exchange rate, as well as domestic demand.

Crucially, examining the respective policy configurations of these four country cases at specific junctures in time highlights the linkages between greater coherence among these three policy areas and more dynamic forms of structural economic transformation. In each of these countries, in order to better reflect domestic development interests, concerns and objectives, policymakers often made selective adaptations to policy instruments and institutional arrangements which did not conform to conventional economic policy advice provided at the time. These country experiences thus reveal (albeit to varying degrees) the attentiveness of national authorities not so much to best practices in policymaking, as to best policy matches with institutional capabilities.

Chile is often held up as a model of adherence to market principles, but in reality its market reforms reflect a more pragmatic and flexible approach, especially in the late 1980s and the 1990s. On the financial side, Chile

embarked upon a process of financial liberalization in the 1970s, eventually completing the process of capital account liberalization by 2001. At the same time, however, the BancoEstado (a state-owned commercial bank) was, and remains, a key player in Chile's financial sector, providing an array of financial services to small and medium-sized enterprises (SMEs) and small savers. The Government also created two specialized programmes to fund collaboration between local firms and research organizations in order to catalyse learning and innovation within domestic industry and foster structural transformation.

Chile has managed to gradually diversify its economy from copper production to other parts of the mining value chain, and has also developed value-added natural-resource-related activities such as the manufacture of food products, forestry and wooden furniture, pulp and paper, and chemicals. The pattern and degree of government policy instruments, institutions and incentives has differed according to initial industry-specific conditions. From the 1980s to the early and mid-2000s, Chile's industrial policy approach prioritized "horizontal" (or "functional") policies, which sought to overcome specific market failures across sectors that built upon existing comparative advantages. In the mid-2000s, however, the Chilean authorities recognized the necessity of also adopting "vertical" policies that involved explicit strategic interventions and investments in selective sectors and firms.

Another important aspect of Chile's export diversification efforts was the role played by the Government in negotiating bilateral and regional free trade agreements (FTAs) with major importers of Chile's goods and services. In most cases, the country successfully managed to overcome potential commercial restrictions against its exports while at the same time maintaining the policy space to pursue its industrial policy strategy, in particular, safeguarding its ability to use macroprudential policies and capital controls.

The coherence of macroeconomic policies, particularly in the 1990s, was also crucial to the overall development strategy. On the one hand, Chile sought to remain open to FDI, but discouraged short-term and speculative inflows. On the other hand, policymakers intervened in foreign exchange markets to manage the exchange rate, while offsetting foreign exchange reserve accumulation by sterilizing their effects on money supply through the issuance of government bonds. This set of policies helped to protect and reinforce its development strategy, which focused on export growth and diversification. However, by the late 1990s, the policy configuration remained the same and was not intensified to counteract a surge in capital inflows at that time, which ultimately rendered the policy mix less effective.

China's transition from a planned economy represents a traditional approach characterized by a gradual and strategic pattern of integration into the global economy. At its heart, the Chinese strategy embodies a "micro-first" approach to economic reforms, rather than a "macro-first" approach favouring economy-wide policy solutions. The former starts by improving incentives, particularly through institutional arrangements, as a necessary initial step towards greater market liberalization.

During much of the reform period, China mobilized resources mainly through retained profits and what is known as "financial restraint", which provided savers with few options but to channel funds into State-owned banks. At the same time, however, the Chinese authorities converted the mono-banking system into a two-tiered banking system, whereby the central bank focused on monetary policy (e.g. currency issuance and keeping inflation in check) and oversight of commercial banks through regulation and supervision, while commercial banks concentrated on the mobilization and allocation of financial resources.

The Chinese sequential approach to reforms was applied first to the agricultural sector. The organization of farming units was changed from a collective system to a "household responsibility system". The Chinese authorities also actively fostered diversification towards higher value crops through publicly funded agricultural research and extension services. Industrial sector reforms that followed in the mid-1980s sought to change the incentive structure of individual firms, while also improving the overall market environment in which those firms operated. Another key industrial sector reform at that time was the selective removal of monopoly power: while the State focused on large-scale, mostly "upstream" sectors, its ownership share was sharply reduced in "downstream" sectors such as printing, furniture and plastic products.

These gradual financial and industrial reforms were accompanied by a coherent macroeconomic framework. The Chinese authorities adopted a restrictive approach to exchange rate policy and capital account opening, reflecting the twin objectives of maintaining domestic macroeconomic stability, while exposing the economy to the benefits of trade and capital flows. This explains why the Chinese currency has been de facto fixed to the dollar since 1995: to avoid appreciation and remain competitive on export markets. At the same time, capital controls adopted an "FDI-first" orientation that favoured FDI inflows, which were considered more stable, over portfolio inflows, which were perceived as more volatile.

Mauritius is another example of gradual and unorthodox economic opening. It pursued a two-track strategy, with part of the economy very open and the other quite closed. Regarding resource mobilization, through the 1980s Mauritius maintained strong controls over its financial system which was dominated by commercial banks. While many of these measures were phased out over the course of the 1990s, the Government maintained its control over the Development Bank of Mauritius (DBM), one of the main public agencies supporting exports. Using subsidized interest rates to support government policy, the DBM was the source of a significant share of the credit and start-up capital used for diversifying the economy from its mono-crop base. In the aftermath of the 2008–2009 crisis, the Government focused more on SMEs, and the DBM was transformed into a bank to support micro, small and medium-sized enterprises.

Up to the mid-1960s, sugar milling and associated activities remained the primary industrial activity until the Government adopted a policy of import substitution to spur export diversification. In 1970, the Government shifted its strategy to promote export-oriented manufacturing by enacting the Export Processing Zone Act, which provided an array of incentives. Mauritius was still a highly protected economy in the 1970s with a high average rate of protection and a dispersed tariff structure, and this policy continued through the 1980s and 1990s, although the level of protection fell over time. The country's unorthodox opening up process was underpinned by preferential access provided by its trading partners to ensure the profitability of its sugar and garments and textile production, which accounted for the large bulk of Mauritian exports, particularly in the 1980s and 1990s.

Mauritius' macroeconomic framework utilized various pegged exchange arrangements in the 1980s to stabilize its currency before switching to a managed float by the mid-1990s. Although, currently, Mauritius has very limited capital controls, the Bank of Mauritius is mandated to first ensure the competitiveness of the country's exports, and second, to maintain price stability.

Viet Nam adopted a set of policies that would fundamentally change the underlying structure of its economy, favouring a gradual “dual-track” economic reform approach over a rapid “big-bang” approach. Its economic “renovation” (*doi moi*) strategy launched in 1986 had two main objectives. The first was to engineer a transition from a centrally planned to a market-based economy by allowing domestic prices to reflect world prices, increasing the

number of entities engaged in trade, removing exchange rate distortions and reforming enterprise governance to allow indirect regulation through market prices. The second objective was to support export-oriented industries to counter the anti-export bias of the previous economic system.

With regard to resource mobilization, Viet Nam embarked on its first major reform of the financial sector in 1988 by establishing a two-tier banking system similar to the one adopted in China.

Viet Nam's renovation strategy began with agriculture, particularly rice cultivation. In 1988–1989 collective farming was dismantled, and the land was divided among farming households, which were recognized as the basic unit of agricultural production. The other major initiative was enterprise reforms to allow greater autonomy over commercial activities and improve the overall market environment, including the entry of foreign-owned firms. Domestic reforms were reinforced with the signing of international trade agreements and partnerships. Despite significantly reducing and binding all tariffs, Viet Nam has recently used flexibilities in the global trade regime to raise tariffs to the bound level for a range of products.

Finally, the country has adopted an unorthodox macroeconomic policy framework that combines a stable, competitive exchange rate with strong controls over inflows and outflows of capital, while also achieving a degree of independence in its monetary policy.

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## **A post-2015 development agenda for LDCs**

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The proposed SDGs are extraordinarily ambitious — far more so than the MDGs. Achieving them would require a rate of structural transformation in LDCs at least comparable to that of the most successful ODCs, and poverty reduction would have to be even faster than in China. Such ambition is welcome, but it is also extremely challenging, especially at a time when global economic prospects are much less favourable than during most of the period since 2000, not to mention the additional challenges arising from climate change.

Furthermore, LDC economies operate in an interdependent global economy where earlier industrializers have already accumulated significant cost and

productivity advantages, making it relatively more difficult for latecomers to upgrade and diversify their production structures. In this context, employing targeted, selective and more ambitious government policies to modify their economic structure and boost economic dynamism is of critical importance.

However there is no single blueprint for policy intervention. Successful countries in the past have employed a variety of different institutional arrangements and policies, encompassing market development, measures for technological upgrading, removal of infrastructural bottlenecks and support to enterprise development. A one-size-fits-all model of development and policymaking is therefore not practical. Rather, a pragmatic approach should be considered, based on a mix of policies selected to suit specific conditions. The types of policy instruments which may help foster structural transformation and enable achievement of the SDGs have been identified in *The Least Developed Countries Report 2014*. It also suggests what reforms to the global economic system and what international support measures for LDCs will be needed.

**Resource mobilization.** Productive investment is central to economic transformation. In most LDCs, however, a combination of underdeveloped financial institutions and limited availability of opportunities for commercially viable productive investment at acceptably low levels of risk contribute to maintaining chronically low investment rates. LDC governments should therefore foster the development of a financial sector oriented towards productive investment, while creating opportunities for private investment in activities that will promote economic transformation.

FDI has played an important role in the extractive industries in many LDCs, and in developing export-oriented manufacturing in others. With appropriate policies and incentives, such investment can be harnessed to support development strategies involving economic diversification and technology transfer. FDI in manufacturing which uses more labour-intensive technologies and generates greater employment opportunities (often South-South) is especially beneficial to LDCs. Productive investment by the diaspora, though likely to be more limited in scale, may have strong development benefits, combining the advantages of domestic investment and FDI.

Development banks can play an important role in mobilizing resources for productive investment. They can promote investment in activities with high social rates of return and encourage complementary and interdependent

investments. They should not be expected to be as profitable as private lenders, in view of their role in generating externalities. Equally, their optimal strategy is not to minimize mistakes, but rather to minimize the cost of mistakes should they occur. The information provided by an unsuccessful investment is also an externality, and its elaboration and dissemination should be an important part of a development bank's activities. This is particularly important with respect to innovative investments.

Investment in infrastructure (e.g. energy, transport and communications infrastructure) is another major means of increasing the profitability of many economic sectors and fostering structural transformation. This is in addition to infrastructure investments required for LDCs to meet the SDGs, such as those in health, education, water and sanitation. The total amount of financial resources needed is likely to amount to more than most LDCs' savings capacities or their governments' limited revenue-raising capacities. FDI could help fill the gap by providing additional resources in some sectors, but this would need to be supplemented by an increase in ODA. The development benefits of ODA can be enhanced through the use of labour-intensive methods and local procurement in infrastructure construction, and appropriate sequencing of infrastructure investment.

For fuel and mineral exporters, resource rents can play a significant role in providing financing for both public and private investment. These rents have the advantage over ODA in that they allow greater flexibility of use, enabling governments to set their own priorities and avoid some of the constraints associated with aid. While receipts from the extractive industries may be volatile and unpredictable, reflecting variations in market prices, expenditure can be smoothed over time — accumulating resources when prices are high, and drawing them down when prices are low — so that rents can serve a stabilization function as well as financing investment. Equally, where extractive industries result in a skewed geographical distribution of income, they can provide a means of redistributing the benefits more equitably across regions.

*Industrial policy.* Economic development is a process of continuous technological innovation, industrial upgrading and structural transformation, which is inherently plagued by market failures. Markets in developing economies are often incomplete or characterized by distortions (such as externalities or the presence of monopolies), and this provides a strong theoretical case for the use of industrial policy to alter the sectoral structure of the economy towards more dynamic sectors and activities. Investment in

new sectors or the use of new production techniques is essential for structural transformation and economic diversification, but it involves considerable uncertainty, and market signals do not reflect its economy-wide benefits. This justifies proactive support for such investment.

The need for a shift from the traditional to the modern sector does not mean that investment should be limited to the modern sector. On the contrary, investment to increase productivity in agriculture is also critically important, as a substantial proportion of the workforce will remain in this sector. Equally, diversification of rural economies away from agriculture, so as to generate off-farm incomes, is an essential complement to structural transformation if it is to achieve a rapid reduction of poverty. Rural electrification using renewable energy technologies could substantially accelerate this process. Structural transformation and poverty reduction can best be combined if the supply of and demand for agricultural and non-agricultural production proceed in parallel.

LDCs need the type of investment that generates a substantial number of jobs, rather than that which reduces employment. Particular opportunities may arise from increasing ODA, from increased demand associated with poverty reduction, and from the development of forward and backward linkages from existing domestic productive capacities and FDI. For mineral and agricultural exporters, in particular, the development of production clusters around natural resources could constitute a potentially valuable step forward in structural transformation. Similar strategies may also be beneficial for other LDCs that have relatively strong agricultural potential.

***Macroeconomic framework.*** The structural transformation necessary to achieve the SDGs sustainably requires macroeconomic policies which promote both investment and demand growth. Increasing productivity requires investment, and investment requires demand growth as a source of productive opportunities. Demand growth is also necessary for labour productivity to grow together with employment. This suggests that the overall macroeconomic policy stance should be relatively expansionary.

Of course, due consideration should be given to financial sustainability and price stability. However, to ensure sustained growth, it is important that monetary policy does not unduly restrict the availability of sufficient credit for productive investment, which is critical for promoting structural transformation. In LDCs, availability of credit will also help small enterprises



to grow and diversify production. In other words, facilitating access to credit is of particular importance. By reorienting credit from consumption towards productive investment, LDCs will be able to broaden the sources of growth and reduce overdependence on imports.

Uncertainties associated with volatility of demand growth are also a potential threat to investment. Deficit targets should therefore allow flexibility for countercyclical policies in economic downturns, particularly in countries heavily dependent on commodity exports. Some tax and social expenditure policies — for example progressive taxation, welfare and social protection policies — can act as automatic stabilizers. In commodity-dependent countries, stabilization funds or variable export taxes can also be important for reducing the volatility of growth.

Finally, successful economic transformation requires exchange rate and trade policies that enable producers to be competitive in domestic and international markets.

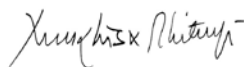
*International measures.* Achieving the SDGs will require considerable efforts by LDC governments, but it will also require a concerted effort by the international community. Most obviously, this applies to aid. The financing requirements for the SDGs are considerable, and structural transformation (as well as adaptation to climate change) will add considerably to the costs. The LDCs will not have the resources to fund all of the necessary infrastructural investment. Increased aid and the honouring of donors' ODA commitments with respect to the amount of ODA and its ways of allocation, management and delivery — particularly the basis of international support of — will therefore need to play a major role. It is especially important that ODA and supports national development strategies and is aligned with them.

Resolving the remaining debt problems of LDCs should be a matter of priority, as also reform of the international financial system to ensure a more effective and pro-development system of crisis prevention and response. The SDGs would be quickly derailed if the serious damage inflicted by the debt crises of the 1980s and 1990s were to be repeated. Compensatory finance for economic shocks could also play a major role in limiting economic volatility. In addition, greater international coordination on taxation to avoid harmful tax competition could contribute to strengthening public revenues. Measures could also be explored to promote productive investment by LDC citizens working abroad.

An effective and equitable solution to climate change is also critical, due to LDCs' particular vulnerability to its impacts. Not only should limits on LDC emissions, which could impede their development, be avoided, but also indirect impacts of changes affecting their exports should be carefully evaluated and fully compensated through support to diversification and complementary trade measures.

In trade, LDCs should enhance their capacity to make full use of duty- and quota-free market access to developed and developing countries. Aid for Trade for LDCs — including through the Enhanced Integrated Framework (EIF) — should be increased and its focus broadened to support the development of productive capacities, while fully recognizing the principle of country ownership. LDCs' accession to the World Trade Organization (WTO) should be facilitated and accelerated. They should also be encouraged and assisted in taking full advantage of the flexibilities available under WTO Agreements for promoting development and structural transformation. International measures are also needed to allow LDCs to harness the benefits of intellectual property for development, including through effective implementation of the Development Agenda of the World Intellectual Property Organization and of the LDC provisions of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights. The ultimate aim of these measures should be the facilitation of technology transfer to LDCs.

The analysis in *The Least Developed Countries Report 2014* reinforces the need for concerted efforts both by the LDCs and the international community to take effective and coherent policy measures aiming at the structural transformation necessary for enabling LDCs to tackle their enormous development challenges in the post-2015 period.



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