UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

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THE LEAST DEVELOPED COUNTRIES REPORT 2016

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

OVERVIEW

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Overview

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Deteriorating economic performance

Following several years of apparent resilience to the international economic and financial crisis, economic growth in the least developed countries (LDCs) has declined steeply since 2012, reaching a low of 3.6 per cent in 2015. This is the slowest pace of expansion this century, and far below the target rate of at least 7 per cent per annum recommended by the 2011 Programme of Action for the Least Developed Countries for the Decade 2011–2020 (the so-called Istanbul Programme of Action (IPoA)). Thirteen LDCs experienced a decline in gross domestic product (GDP) per capita in 2015. This performance has been strongly influenced by the sharp decline in commodity prices, which has particularly affected African LDCs. Such weak economic growth is a serious obstacle to generating and mobilizing domestic resources for structural transformation and investment in the development of productive capacities. It also hampers progress towards the United Nations Sustainable Development Goals. This economic slowdown is likely to be reinforced by the current world economic climate, which remains lacklustre in its recovery.

Depressed exports as a result of falling commodity prices, with a smaller decline in imports, have also led to a doubling of the merchandise trade deficit of LDCs as a group from $36 billion in 2014 to $65 billion in 2015. The largest increase in the merchandise trade deficit took place in the subgroup of African LDCs and Haiti. The services trade deficit fell somewhat for the LDCs as a group, from $46 billion in 2014 to $39 billion in 2015, as a shrinking deficit across African LDCs and Haiti more than offset an increasing deficit across Asian and island LDCs. These developments largely account for an increase of almost one third in the LDC current account deficit to a record $68.6 billion in 2015, a trend that is expected to continue over the medium term.

Domestic resource mobilization has been recognized by the Addis Ababa Action Agenda of the Third International Conference on Financing for Development and the 2030 Agenda for Sustainable Development (2030 Agenda) (both adopted in 2015) as an important process for LDCs to finance their development. However, this objective remains elusive for most LDCs due to their external resource gaps, the complexity of their development challenges, their narrow tax bases, deficiencies in tax collection and administration, resources forgone due to illicit financial flows, and the underdevelopment of their domestic financial sectors. The external resource gap of LDCs as a whole increased to 3.2 per cent of GDP in 2014, due mainly to an increase in fixed investment in Asian LDCs that was not accompanied

by a corresponding rise in their domestic savings. If LDCs are to raise their fixed investment, as is essential for structural transformation, the deficit will inevitably widen in the coming years, particularly in view of the enormous financing needs associated with the Sustainable Development Goals.

The resources gap is financed by a mixture of official and private financial flows. Official development assistance (ODA) to LDCs declined by 12.2 per cent in 2014 to $26 billion — some 27 per cent of total aid to developing countries as a whole. Foreign direct investment (FDI), by contrast, rose by one third to $35 billion (9.5 per cent of the developing-country total), most being directed to African LDCs. Contrary to worldwide trends, workers' remittances to LDCs also rose in 2015, reaching $41.3 billion. They exceeded 20 per cent of GDP in the Comoros, Haiti, Liberia and Nepal.

The economic outlook for LDCs as a group for the next two years remains uncertain in the face of a lacklustre global economic environment that is depressed by weak demand in developed countries, a continuing slowdown of international trade, a sharp decline in growth or even recession in many developing countries, and high or rising debt in both developed and developing countries. In some LDCs, the prospects are aggravated by risks in the domestic political environment. Nevertheless, the real GDP growth of LDCs as a whole is forecast to recover somewhat to 4.5 per cent in 2016 and 5.7 per cent in 2017, though remaining below the IPoA target.

Graduation: A milestone, not the winning post

The IPoA includes a target that at least half of the LDCs should satisfy the criteria for graduation from LDC status by 2020. This was a bold step by the international community, putting LDC graduation firmly on the global agenda. The midpoint between the adoption of this target and the target date is an opportune time to evaluate the prospects for its fulfilment and to review the significance, nature and process of graduation.

Graduation is the process through which a country ceases to be an LDC and becomes one of what this Report terms "other developing countries" (ODCs). The significance of this step emerges from the rationale behind the LDC category itself. Its establishment in 1971 reflected a recognition that certain countries faced particularly serious obstacles to achieving the structural transformation needed to advance economically and socially. The

international community adopted special international support measures (ISMs) for LDCs to enable them to escape from the intersecting vicious circles that prevented their economic progress, and to derive developmental benefits from the global economy. This required the development of clear criteria to define which countries should be eligible for such measures.

There are three major vicious circles affecting LDCs. First, many LDCs suffer from a poverty trap, with low income and limited economic growth giving rise to high levels of poverty, which in turn act as a brake on economic growth. In spite of the progress achieved in the era of the Millennium Development Goals (2000–2015), it is in LDCs that poverty has been and remains most pervasive, with almost half of their total population still living in extreme poverty. Two thirds of the labour force of LDCs work in mostly smallholder agriculture, a sector suffering from chronically low labour productivity. Productivity growth has been constrained by the adverse impact of risk aversion on investment, and often by limits to access to and adoption of new technology.

Second, many LDCs suffer from a commodity trap, as they depend heavily on commodity production and trade for employment, income, savings and foreign exchange. In the overwhelming majority of LDCs (38 of the 47 for which data are available), commodities accounted for more than two thirds of merchandise exports in 2013–2015. Commodity dependence increases vulnerability to exogenous shocks (such as adverse terms of trade movements, extreme meteorological events and climate change impacts). It also often gives rise to a "natural resource curse", when exchange rate appreciation undermines the competitiveness of the manufacturing sector or when rent-seeking behaviour prevails, and there are limited incentives for public and private incentives to invest, even in human capital. Like poverty traps, commodity dependence tends to be persistent. LDCs face difficulties in upgrading within global value chains and are often kept locked into specialization in primary commodities and low-value-added products. With a few notable exceptions (Afghanistan, Burundi, the Comoros, the Solomon Islands and Uganda), there is little evidence of a significant reduction in primary commodity dependence since the beginning of the century.

Third, weak productive bases and limited export diversification in LDCs give rise to a very high import content in production and consumption, and chronic current account deficits. These factors in turn result in aid dependence and the accumulation of foreign debt. These factors can also weigh heavily on the growth rate, as imports of capital goods and intermediate goods for investment projects may be reduced while essential imports such as food and fuels absorb the available foreign exchange.

Thus graduation, in principle, should mark the point at which an LDC has risen sufficiently from these vicious circles to rely primarily on its own strengths and on international markets for its subsequent development, without requiring the maximum concessionary treatment from development partners. In brief, graduation is normally expected to mark a move from economic dependence to a state of greater self-reliance.

Graduation from LDC status needs to be viewed as part of a longer and broader development process, in which economic growth should both result from and contribute to the development of productive capacities and a process of structural transformation. The latter entails an upgrade in the country's economic activities and helps to increase resilience to exogenous shocks.

Graduation is thus not the winning post of a race to cease being an LDC, but rather the first milestone in the marathon of development. It represents the end of a political and administrative process, in which the institutions responsible for inclusion in and exclusion from the group of LDCs take decisions based on statistical and other criteria. However, it does not mark the completion of an economic and developmental process.

Formally, an LDC is eligible to graduate if, in at least two consecutive triennial reviews of the list of LDCs by the Committee for Development Policy (CDP), it complies with one of two conditions: either it meets the graduation threshold of at least two of the three LDC criteria (gross national income (GNI) per capita, the human assets index (HAI) and the economic vulnerability index (EVI)); or it reaches a level of income per capita of at least double the graduation threshold for that criterion (the "income-only" graduation rule). The actual decision on graduation, however, does not follow mechanically from the satisfaction of these conditions: the specific circumstances of each country, especially its vulnerability, and the likely impact of graduation and the ensuing loss of LDC treatment are also taken into account.

In contrast to the ambition of the graduation target set by the IPoA, and contrary to expectations when the LDC category was established, the number of LDCs doubled from the original list of 25 in 1971 to a peak of 50 between 2003 and 2007, before decreasing to 48 in 2014. This partly reflects the fact that only four LDCs have graduated in the 45 years since the establishment of the category: Botswana (1994), Cabo Verde (2007), Maldives (2011) and Samoa (2014).

The limited number of graduations to date reflects a marked divergence of development paths among developing countries, with dynamic "emerging

market economies" leaving the LDCs well behind in many respects. The per-capita income gap between LDCs on the one hand and ODCs and countries with economies in transition on the other has consistently widened since 1981. This divergence largely reflects the increasing gap in the productive capacities of the two groups, a gap mirrored by large differences in the social indicators.

The gap in social indicators is of particular importance in the context of the 2030 Agenda: as noted in previous *Least Developed Countries Reports*, LDCs will be the battleground on which the 2030 Agenda will be won or lost. Achieving the Sustainable Development Goals in LDCs will require major breakthroughs in the development of productive capacities, structural transformation, technological upgrading, economic diversification, productivity and job creation, some of which lie beyond the explicit targets of the Goals themselves. Thus, for LDCs to meet the Sustainable Development Goal targets in full would entail not only graduation in a formal sense, but graduation as part of a broader and longer-term process of economic transformation — what this Report terms "graduation with momentum".

The very limited number of LDC graduation cases to date is also in part indicative of major shifts in the international economic environment in recent decades, as market-based flows, especially of international trade and international investment, have increased in importance in the global economy. As a result, the success of developing countries has become increasingly dependent on fruitful engagement with export markets, particularly in higher-value segments of global value chains, including by means of appropriate strategic FDI policies. This gives rise to a growing need to compete, which intensifies the challenge posed by the widening gap in productive capacities between ODCs and LDCs. LDCs have been further disadvantaged by the relative decline in ODA, on which they are much more reliant than ODCs. The impact of the decreasing importance of ODA in international flows is compounded when the geographical allocation of aid does not benefit the neediest countries, and when its sectoral allocation is only weakly focused on the building of productive capacities.

The conceptualization of graduation as a milestone rather than a winning post has important implications for LDCs' approaches to development and to graduation. Just as it is inadvisable to sprint for the first kilometre of a marathon, it is not enough simply to target achievement of the criteria needed for graduation. It is also of paramount importance to establish the foundations needed to maintain development progress beyond graduation. This means approaching the graduation process with a view to longer-term development

needs, rather than focusing only on the graduation criteria themselves. The latter approach risks diverting attention and resources from other aspects of development which, though not fully reflected in the criteria, will be critical long after graduation has been achieved.

Thus, the goal is not graduation per se, but graduation with momentum, which will allow the development trajectory to be maintained and pitfalls to be avoided far beyond graduation: in the long term, ***how*** a country graduates is at least as important as ***when*** it graduates. This indicates a need to move beyond graduation strategies oriented to the achievement of the graduation criteria, towards "graduation-plus" strategies directed to graduation with momentum and establishment of the conditions for a viable long-term development process.

While the development that leads a country to graduation is clearly beneficial, the loss of LDC status at graduation may give rise to potentially important economic costs as a result of the loss of access to the ISMs associated with LDC status. The magnitude of such costs depends on the extent to which the country concerned benefited from such measures before graduation. The need for ISMs is likely to be greatest at early stages of development, when the ability to compete in international markets is most limited. However, the potential to exploit and benefit from some ISMs, particularly preferential market access, largely depends on the level of productive capacities, which becomes higher as a country moves towards graduation. In a country where productive capacities expand in export sectors that are largely covered by trade preferences, and these preferences have been utilized, their loss may be a major cost. This highlights the importance of a smooth transition process in such cases, and of early preparation for the consequences of graduation as part of "graduation-plus" strategies.

National policy approaches to graduation depend not only on economic considerations but also on a political calculus of which the economic calculus forms a part. This includes the potential for a "kudos effect" domestically — the opportunity for a government to gain political advantage by claiming responsibility for having brought a country from LDC status to parity with other developing countries. Such considerations may have encouraged some LDC governments to develop strategies specifically oriented towards graduation by a specified date.

While some LDC governments resisted the idea of graduation during the 1990s and early 2000s, many now seem to take a much more positive view, interpreting reclassification as synonymous with irreversible progress and a

reflection of their proactive efforts to achieve such progress. This apparent change of attitude could in part reflect the political dividends offered by graduation, combined with the declining economic effectiveness of some of the ISMs.

The national dynamics of graduation

During the 45 years since the establishment of the LDC category, despite the domestic efforts of LDCs themselves and the impact of ISMs with the stated objective of strengthening their development processes, only four countries have succeeded in graduating from LDC status. This raises the question of why the development performance of LDCs has been so disappointing in both its domestic and international dimensions. Answering this question requires an understanding of the processes through which LDCs can exit from underdevelopment and achieve graduation.

To date, the countries which have achieved graduation comprise one landlocked mineral exporter in Africa (Botswana) and three small island economies that predominantly export services (Cabo Verde, Maldives and Samoa). For the purposes of this Report, a simulation was conducted to assess which LDCs were likely to graduate in the 2017–2024 period (without prejudging decisions by the CDP, the Economic and Social Council (ECOSOC) the United Nations General Assembly or LDCs themselves).

This exercise indicates that the number of graduations in the coming years is likely to fall well short of the IPoA target, showing only 10 countries as meeting the graduation criteria by 2020, against a target of 24. By 2025, only 16 countries are projected to have graduated. These 16 countries include all but one (the Comoros) of the seven small island LDCs and all but one (Cambodia) of the eight Asian LDCs, but only three (Angola, Equatorial Guinea and Djibouti) of the 33 LDCs in the Africa and Haiti group.

Despite their major structural handicaps (high environmental vulnerability due to high exposure to natural disasters, economic remoteness, smallness of domestic markets and a high dependence on ODA and remittances), small island developing States (SIDS) tend to perform relatively well in terms of graduation. This partly reflects their relatively large human asset endowments (reflecting their achievements in education and health) and high per-capita incomes (relative to other LDCs), although these positive features are counterbalanced by their high economic and environmental vulnerability.

Conversely, being landlocked presents many LDCs with additional challenges that are a greater obstacle to graduation. The landlocked developing countries (LLDCs) among the LDCs generally perform considerably less well than other LDCs, reflecting their more limited export diversification and productive capacities, lack of export competitiveness, economic remoteness and dependence on the economic and political situations of neighbouring (transit) countries. However, these challenges do not prevent some landlocked LDCs from achieving positive development outcomes or graduation, as attested by the first graduation case (Botswana) and the presence of four LLDCs among the LDCs projected to graduate before 2025.

While the structural handicaps outlined above may jeopardize structural transformation and development, the historical success of four LDCs in graduating and the projected future graduation cases demonstrate that neither underdevelopment traps nor disadvantageous geographical features are insurmountable obstacles to graduation. Successful development depends upon national and international policies and strategies that address the root causes of these underdevelopment traps, and kick-start the process of sustainable development.

None of the four ex-LDCs carried out policies with the explicit goal of graduation. Botswana's development policies were based on the efficient capture and use of mineral rents, and effective investment in education and physical infrastructure. The other three graduates (Cabo Verde, Maldives and Samoa) owe their graduation to sound policies to develop a competitive tourism sector and other services sectors (for example, offshore financial and legal services in Samoa), together with investment in the fisheries industry and in human capital. A strong influx of ODA and remittances was instrumental in supporting various forms of structural economic progress in Cabo Verde and Samoa.

The current LDCs, by contrast, tend to direct their strategies more explicitly towards graduation. Those countries that are close to graduation thresholds tend to adopt graduation as a major national goal and typically develop programmes targeting specific components of the graduation criteria. Often, the goal of graduation is set in the context of long-term development plans that aim at attaining the status of a middle-income country or even an "emerging market" economy.

Those LDCs that are further below graduation thresholds, by contrast, tend to aim at increasing per-capita income, and often implement strategies and programmes aimed at broad-based sustainable development. To that end,

they typically focus on issues such as domestic resource mobilization, rural development, diversification of production and exports, raising productivity and increasing disaster preparedness.

UNCTAD's graduation projection exercise highlights the different growth and development paths that can lead to graduation. Some, but not all, of the 16 countries that are projected to have graduated by 2025 are likely to achieve graduation with momentum through broad-based development of productive capacities, diversification and structural economic transformation. This is the case for some manufactures exporters (Bangladesh and Bhutan) and mixed exporters (the Lao People's Democratic Republic and Myanmar). When graduation is achieved through a broader process of economic and social development, including progress towards structural transformation and economic diversification, it is likely to be more inclusive and to provide more solid foundations for continued development in the post-graduation phase.

However, by no means all graduates will achieve graduation with momentum: some LDCs are projected to reach graduation without having undergone meaningful structural economic transformation. This may be the case, in particular, for economies based on fuel extraction and, to some extent, SIDS. While fuel extraction boosts income, in most cases it does not lead to diversification or to commensurate social and economic inclusion, and does not necessarily provide a basis for sustainable development progress. Achieving these last goals requires policies and strategies to reinvest resource rents in productive-capacity development in other sectors beyond the extractive industries.

The past and projected graduation cases indicate that SIDS typically graduate through a combination of limited diversification towards services and investment in human capital. However, this is not enough for strong structural economic transformation, which requires a greater degree of diversification and advances towards higher-value-added sectors and activities.

The projections conducted for this Report have important implications for the composition of the LDC group over the next decade. In 2025, if the projections prove broadly correct:

- The LDC group would be composed of 32 countries, all but two (Cambodia and Haiti) in Africa;
- There would be only one SIDS (the Comoros), while coastal countries would represent a small majority of the total (17 of 32), only slightly outnumbering LLDCs (14);

- Commodities would continue to play a major role in the economy of the group as a whole; and
- The development challenges facing the group as a whole would be intensified, with greater reliance on agriculture for output and employment, higher poverty rates, low average labour productivity, and a higher degree of aid dependence. In the absence of more decisive and efficient development policies, the development gap between the remaining LDCs and ODCs would thus be even wider than at present, requiring heightened attention from both national authorities and the international community.

Differences in graduation performance highlight an increasing differentiation within the LDC group. While some LDCs are achieving visible progress in terms of building productive capacities, diversifying their economies and moving resources to higher-value-added sectors and products, others remain at the initial stage of these processes.

It is of utmost importance that the States and organs influencing or deciding the cases of graduation (LDCs themselves, the CDP, ECOSOC and the General Assembly) continue to take due account of factors other than statistical eligibility for graduation. Moreover, the possibility of graduation without structural transformation points to the need to reconsider the graduation criteria, and to reflect more fully the long-term development processes that these countries are undergoing.

The contribution of international support measures to graduation

The effectiveness of ISMs for LDCs is coming under greater scrutiny as growing emphasis is placed on the monitoring and evaluation of international support. This issue should be addressed in terms of the contribution of ISMs to enabling LDCs to overcome the structural handicaps and exit from the "traps" that limit their development of productive capacities and progress towards structural transformation — that is, in terms of their contribution to graduation with momentum.

ISMs for LDCs encompass a range of measures, commitments and provisions across the fields of development finance, trade, technology and technical assistance. The widening divergence between LDCs and ODCs in

terms of income and productive capacities is indicative of shortcomings in their development models, strategies and policies, and/or of the ISMs that have been put in place in their favour. By making a greater contribution to the development of productive capacities in LDCs, more effective ISMs would have helped to limit the divergence between LDCs and ODCs. The failings of LDC-specific ISMs, in turn, reflect a combination of inappropriateness, diminishing effectiveness, insufficient funding, inadequate institutional settings and insufficient uptake.

There are 139 special and differential treatment (SDT) provisions benefiting developing countries (including LDCs) in the agreements of the World Trade Organization (WTO), of which 14 are specific to LDCs. Several decisions concerning LDCs have also been adopted since the inception of WTO. These provisions vary greatly in breadth, relevance and effectiveness. They have various objectives, notably to facilitate compliance with WTO rules, for example, through extended implementation periods. Some call on WTO members to provide assistance in various forms to LDCs; but these are generally limited to "best endeavour" language rather than being enforceable obligations. LDCs are also accorded some special rights with respect to protection and promotion of economic activities, allowing them somewhat greater policy space. However, the benefits of SDT provisions depend on awareness of their existence and terms, which varies widely among LDCs. Often LDC governments and firms do not make use of existing preferential measures (for example, flexibilities under the WTO Agreement on Trade-related Investment Measures (TRIMs Agreement) or under the WTO Agreement on Subsidies and Countervailing Measures) because they are not aware of them. Effective use of such preferential measures also depends on institutional capacities, financial resources and productive capacities.

Preferential market access is a major ISM available to LDCs, helping to offset the higher production and trade costs associated with their structural and geographical handicaps. While the majority of LDCs consider their major exports to be covered by duty-free quota-free (DFQF) schemes in developed countries, these often exclude some sensitive products in which LDCs have export capacity, such as clothing, textiles and some agricultural products. Although most existing preferential schemes cover the overwhelming majority of products, the exclusion of even a few tariff lines may entail huge losses, given the high concentration of LDC exports. Moreover, the benefits of duty-free market access have been progressively eroded as tariff levels more generally have declined, eroding preference margins.

Utilization of the preferences available is often limited by supply-side constraints, trade-policy-related obstacles (stringent rules of origin, low preference margins, product coverage and non-tariff barriers), lack of awareness, and the unpredictability of preferences due to their discretionary nature. However, the guidelines for preferential rules of origin for LDCs adopted at the Tenth WTO Ministerial Conference in December 2015, if implemented, could contribute substantially to easing this particular constraint on preference utilization. Preferences for LDCs in trade in services have also been permitted since December 2011, although the effective implementation and the expected commercial and developmental benefits of the so-called services waiver remain to be seen.

In the 2001 Doha Ministerial Declaration, WTO members agreed "to work to facilitate and accelerate negotiations with acceding least developed countries", and guidelines to this effect were operationalized in 2012. However, all the LDCs that have sought to join WTO since its creation have faced some degree of difficulty in the accession process, and there have been complaints from LDCs, individually and collectively, about the nature of the procedures and the demands that have been made on them in the course of negotiations.

Institutional constraints and limitations within LDCs are a key obstacle to their ability to use ISMs effectively, particularly in the trade arena. This makes trade-related technical assistance, notably through the Enhanced Integrated Framework (EIF), a particularly important ISM. Despite increasing support from the EIF, however, the IPoA target of increasing the share of LDCs in trade-related technical assistance has not been fulfilled: their share was no higher in 2014 than in 2011, when the IPoA was agreed.

The IPoA also repeated the targets of the Programme of Action for the Least Developed Countries for the Decade 2001–2010, adopted at the Third United Nations Conference of the Least Developed Countries in 2001, that donors should provide ODA to LDCs equivalent to 0.15–0.20 per cent of their GNI. The ratio for major donors as a whole more than doubled between 2001 and 2011. However, even at its peak the ratio was less than half the lower threshold, and it has since fallen back further. The gap between actual disbursements and the lower bound of the 0.15–0.20 per cent target has increased from $25 billion at the time of the IPoA (2011) to $30 billion in 2014. Available data also suggest limited progress on the 2001 commitment to increase the proportion of ODA to LDCs that is not tied to purchases from the donor country.

Climate change adaptation and mitigation need to play a central role in LDCs' development and graduation strategies. The United Nations Framework Convention on Climate Change (UNFCCC) recognizes the necessity of financial and technical support for their adaptation. However, while numerous funds have been established for adaptation, this has given rise to a complex architecture of multiple bilateral and multilateral agencies; some of the funds which exist remain seriously underfunded, and accessing funds is complex and time-consuming, particularly for countries such as LDCs with limited institutional capacity. The LDC Fund (LDCF), established in 2001, has financed the development of national adaptation programmes of action (NAPAs) in all but one (South Sudan) of the LDCs. However, total contributions to the LDCF remain below $1 billion, while the cost of implementing the NAPAs is estimated at $5 billion and expected to increase further over time. In October 2014, the LDCF was declared empty; and it remains to be seen how much of the pledges to climate funds made at the twenty-first session of the Conference of the Parties to the UNFCCC (COP21, held in 2015) will be forthcoming, and how much of this will be devoted to the LDCF.

Building technological capabilities is an essential component of sustainable development and of graduation with momentum. Nevertheless, existing ISMs make little contribution to technological upgrading in LDCs. These countries benefit from a waiver of most obligations under the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS Agreement) until 2021 (and 2033 for pharmaceuticals). However, the use of this waiver is restricted by TRIPS-plus obligations included in bilateral and regional trade and investment agreements, and by the low technological capabilities of LDCs. Under article 66.2 of TRIPS, developed countries are required to provide incentives for enterprises and institutions to promote technology transfer to LDCs; but in practice there have been very few effective measures taken in respect of this obligation. This ISM has therefore failed to provide a meaningful contribution to graduation with momentum.

Technology transfer also has a critical role in climate change adaptation and mitigation. During COP7 (held in Marrakesh in 2001), as part of the Marrakesh Accords, Parties to the UNFCCC established the Marrakesh Technology Framework, under which each LDC is expected to submit a technology needs assessment (TNA) to identify its mitigation and adaptation technology needs; and the COP has pledged to fund the production of such TNAs in full. As of 2015, however, only half of LDCs had submitted a TNA, and only nine had developed technology action plans as part of this process.

The major mechanism for climate-related technology transfer is the Clean Development Mechanism (CDM), which allows developed countries to meet

their emissions-reduction obligations in part by financing emissions-reducing projects in developing countries using technologies unavailable in the host country. To date, however, such projects have been overwhelmingly located in more advanced developing countries (70 per cent in Brazil, China and India alone in 2010); and only 30 per cent of projects claim to offer technology transfer. By the end of 2012, there had been only 12 CDM projects in 7 LDCs.

To strengthen the technology component of the international support architecture to LDCs, the international community has decided to establish the United Nations Technology Bank for the Least Developed Countries. However, its effectiveness and contribution to graduation with momentum will only become apparent after the beginning of its operations, scheduled for 2017.

In the field of financing for development, ODA played an important role in the graduation of the four countries that have graduated to date. This partly reflects the small size of these countries (with populations of between 0.2 million and 1.5 million at the time of graduation) and the strong tendency for such small countries to receive much more ODA, both in per-capita terms and relative to GNI, than larger countries. Equally important for most of them, however, was the proactive approach their governments took to managing ODA receipts and orienting them towards their respective development plans. Trade-related ISMs played a much smaller role in these graduation cases, reflecting these countries' position as exporters mainly of primary commodities (Botswana) or services (Cabo Verde, Maldives and Samoa). However, Maldives benefited from preferential access to the European Union market for its fish exports.

To deepen the understanding of the perceived effectiveness of ISMs by present LDCs, UNCTAD has carried out a survey of LDC officials. The results suggest that they consider ISMs insufficient to support development challenges in LDCs, while also confirming that institutional capacity is an important constraint to LDCs' ability to make effective use of ISMs. Most respondents reported the use of one or more SDT provisions, although this varied widely across provisions. Preferential market access, flexibilities in commitments and the EIF are widely used, while little utilization was reported of SDT provisions relating to agreements on TRIMs, sanitary and phytosanitary measures, and technical barriers to trade. The survey also indicated that LDCs face difficulties in the WTO accession process, in making use of existing flexibilities, and in participating in negotiations.

Respondents generally considered access to development finance insufficient to achieve the IPoA targets, but most saw aid management policies as having improved. However, particular concern was raised about the effectiveness of technology-related ISMs, respondents citing limited technology transfer and difficulties in tracing it to ISMs. While growing international recognition of LDCs' needs in the context of climate change was acknowledged, concerns were expressed about the wide disparity between funding pledges and actual contributions, additionality to ODA, lack of technical capacity in LDCs and lack of systematic information about the funds.

Overall, existing ISMs remain largely inadequate to the developmental needs of the LDCs, making a limited contribution to the development of LDC productive capacities or to the acceleration of their progress towards graduation. The shortcomings of ISMs have become more critical in light of the ambitious targets of the 2030 Agenda and the IPoA. The effectiveness of the existing ISMs is undermined, to varying degrees, by vague formulation, non-enforceability of commitments, insufficient funding, slow operationalization and exogenous developments in international trade and finance. A viable institutional framework and a concrete operational mandate closely aligned with LDCs' needs and developmental interests are essential to effectiveness. Nonetheless, the experiences of past LDC graduates and the views of some current LDCs suggest that some of the existing ISMs can play an important role in supporting graduation. This applies particularly to preferential market access for those LDCs that can make most use of it, and to ODA to small economies.

However, the contribution of ISMs to LDC graduation and development depends critically on the institutional capacities of each individual LDC and its ability to leverage the available mechanisms strategically in pursuit of its own development and graduation agenda. It is thus critical that institutional capacity constraints are taken into account in the design of ISMs, including by combining the establishment of these measures with the provision of related technical assistance.

Post-graduation processes and challenges

An LDC's prospects for sustainable development after it has graduated are strongly influenced by the processes that lead it to graduation, including its economic specialization or diversification, the type of structural

transformation it undergoes, and the policies it puts in place. While graduation from the LDC category in principle indicates greater resilience and/or reduced exposure to structural vulnerabilities, graduates can be expected to remain more vulnerable than other developing countries, not least as a result of geographical challenges such as landlocked position, small size and remoteness. It is thus imperative that such long-term challenges should be taken into account in the design and implementation of national graduation strategies, to avoid the risk of recurrent shocks when the country no longer has access to LDC-specific support measures.

Following graduation, there is a "smooth transition" period of up to nine years from the effective date of graduation, during which LDC-specific support is phased out gradually and predictably so as to avoid disrupting the country's development progress. While many trading partners (for example, the European Union) have adopted a policy of extending their LDC-specific trade preferences for a transition period, this is not the case for all LDCs' development partners. Moreover, there is little clarity regarding smooth transition procedures for other ISMs, such as ODA allocations, aid modalities and technical assistance. The absence of a systematic approach to smooth transition means that the ability of a graduating country to make use of SDT provisions following graduation is heavily dependent on its ability and efforts to mobilize technical, financial and political support from its trading partners, and from bilateral and multilateral development partners.

The full costs of graduation are felt only once the smooth transition period has elapsed. A broad assessment of the economic implications of LDC graduation suggests that the phasing out of LDC-specific support ultimately entails some adverse effects and additional costs, but that the related losses are in most cases relatively limited and should not be exaggerated. Moreover, graduates can typically benefit from other support measures (such as different financing windows and SDT provisions for ODCs) that provide a certain degree of continued support, though less generous than those accorded to them before graduation.

In relation to development financing, there is in principle little reason why LDC graduation should, in itself, have any effect on private capital flows such as remittances and portfolio investment. Graduation (or the prospect of graduation) may discourage FDI inflows motivated by preferential market access that may be lost as a result. However, most FDI flows are shaped primarily by long-term trends in macroeconomic fundamentals and institutional development (notably economic growth, domestic market, labour force qualification, technological capabilities), which ultimately underpin the process of graduation itself.

Concerning ODA, there is little evidence of a positive "LDC effect" on aid allocations, notwithstanding the LDC-specific ODA target. Aid allocations are dictated not only by the needs of recipient countries, but also — especially in the case of bilateral donors — by donors' strategic and political considerations. A different issue arises in the case of multilateral donors, many of which have formal eligibility criteria for their concessional windows. The International Development Association (IDA) of the World Bank — the largest multilateral funder of LDCs — defines eligibility essentially on the basis of a threshold level of GNI per capita, which is close to the LDC graduation threshold. The IDA eligibility criteria are also largely applied by the regional development banks for Africa, Asia and the Americas.

Graduation of an LDC is unlikely to trigger sharp changes in its access to development finance, although it may entail some increase in its cost by reducing its concessionality. Similarly, there is little reason to expect graduation to trigger a sudden decline in Aid-for-Trade financing, especially since the main LDC-specific programme, the EIF, already has well-established procedures for smooth transition. Overall, concerns over the costs of graduation in terms of reduced access to concessional financing upon graduation seem to be exaggerated.

In the international trade arena, the main implication of LDC graduation is the phasing out of SDT provisions favouring LDCs, leading (according to the particular agreement or arrangement) either to less favourable SDT provisions available to ODCs, or in some instances standard provisions for all non-LDC economies. Of particular importance in this respect is the loss of preferential market access under LDC-specific schemes (such as the European Union's Everything But Arms Initiative and the concessions granted to the LDCs under the Global System of Trade Preferences among Developing Countries).

For the purposes of this Report, a simulation was conducted of the potential consequences for LDCs of losing their trade-preference margins in the main G20 (Group 20) markets. This found that the loss of LDC-specific preferential treatment in the G20 countries is on average equivalent to a 3–4 per cent reduction in merchandise export revenues, depending how the preference margin is computed. Extrapolating this result to all 48 LDCs suggests that the loss of preferential market access to the G20 countries might reduce total LDC merchandise exports by more than $4.2 billion per year. The greatest effect would be on those exports for which tariffs are generally highest for non-LDCs, namely agricultural commodities, apparel and textiles, while effects on exports of energy products, mining and ores, and wood products would be limited, as these products face relatively low tariffs regardless of LDC status.

In the context of WTO, graduation could entail some erosion of policy space, for example, in relation to intellectual property rights, industrial policy (TRIMs) and agricultural subsidies, as well as requiring some adjustments to the country's legal framework to comply with the newly applicable WTO discipline (for example, putting in place full TRIPS compliance). Early efforts to map and address such adjustments are advisable. In this context, it is important, ahead of graduation, to anticipate post-graduation challenges and devise appropriate coping strategies to limit their adverse impacts.

Beyond the immediate adjustment to the loss of access to ISMs, LDCs also need to be forward-looking, in order to plan for the broader development challenges typical of the post-graduation phase. Such challenges include, in particular, commodity dependence, the risk of reversion to LDC status, and the "middle-income trap".

Commodity dependence is expected to remain a major feature of many LDC graduates, as it is for many lower-middle income ODCs. Commodities make a major contribution to the exports of the graduates of 2017–2024, except for the manufactures exporters (Bangladesh and Bhutan) and the service exporters (Nepal, Sao Tome and Principe, and Vanuatu); and there is no assurance that they will escape commodity dependence or the associated challenges.

Reversion to LDC status is at least a theoretical possibility, despite the existing precautions (such as different thresholds for inclusion in and exclusion from the category, grace period, smooth transition and consideration of country circumstances). Some countries may graduate by narrowly meeting the graduation thresholds without having acquired sufficient resilience or built a sufficiently solid and diversified productive base to ensure the sustainability of their development progress. While no graduating country has ever reverted to LDC status, the risk of such an outcome is increased by the likelihood of a difficult global economic environment in the coming years and by the prospect of intensifying impacts of climate change, to which some LDCs are particularly vulnerable.

While the likelihood of reversion to LDC status is at present limited, the risk of graduates of falling into a middle-income trap at some point after graduation is much greater. The various characterizations of the middle-income trap — limited likelihood of transition to a higher income group, lack of income convergence towards a benchmark advanced country, and frequency of growth slowdowns — closely mirror phenomena typically experienced by LDCs. Avoiding the middle-income trap after graduation requires anticipation

of its underlying causes in the pre-graduation period and achieving the structural transformation that characterizes graduation with momentum.

The path to graduation and beyond

This Report advocates that LDCs should approach the quest for graduation from the perspective of the development of productive capacities in order to achieve graduation with momentum. This means giving the highest priority to structural transformation of the economy and development of productive capacities, including shifting production and exports to higher-value-added products and sectors, upgrading technology, diversifying the economy and raising productivity. This view mirrors the Sustainable Development Goals, not only in explicitly addressing structural transformation and industrialization, but also in emphasizing the need for an integrated approach in which the social pillar of sustainable development is complemented by strong economic and environmental pillars.

The graduation-with-momentum perspective entails targeting longer-term development and the processes that underlie it, rather than focusing narrowly on the graduation criteria and adopting measures aimed at achieving statistical eligibility for graduation. If development strategies are underpinned by such a broader and longer-term sustainable development perspective, this will allow the graduation criteria to be met, as well as achieving the structural transformation central to graduation with momentum.

Graduation is a milestone in a long-term socioeconomic development process, not the winning post in a race to leave the LDC group. It marks only the end of an initial stage of development, at which point LDC-specific ISMs are phased out. The development process, essentially rooted in a sustainable expansion of productive capacities and increased sophistication of the productive base, continues indefinitely beyond this point, and development challenges do not cease to exist at a particular level of income. The importance of such a perspective is highlighted by the challenges faced by countries at more advanced stages of the development process as a result of constraints on the development of productive capacities or failures of structural transformation, notably the middle-income trap.

The key importance of attaining graduation with momentum, rather than simply graduating, indicates a need to move from graduation strategies focused on satisfying the statistical graduation criteria to what this Report

calls “graduation-plus” strategies, aimed also at establishing the foundations for a continuing development process beyond the graduation milestone. This implies mobilizing different instruments and planning techniques for addressing macroeconomic and sectoral development challenges. While these instruments must clearly reflect national specificities and priorities, certain types of policies are likely to feature in any effective graduation-plus strategy. This Report groups such policies into six areas for action, while highlighting gender as a cross-cutting issue.

Rural transformation: As highlighted in *The Least Developed Countries Report 2015*, structural transformation in LDCs cannot overlook the key role of rural development. Redressing chronic underinvestment in agriculture remains a key priority for most, if not all, LDCs, and requires building essential infrastructure, upgrading farming technologies and practices, and developing agricultural research and development and effective extension services. Rural economic diversification, through the development of non-farm activities, has an important complementary role.

Industrial policy: The main objective of industrial policy is to “nudge” economic agents to bring about a shift from lower- to higher-productivity sectors and activities, exploiting more intensively those sectors that are consistent with current comparative advantage, while also encouraging the expansion of sectors of a somewhat higher level of sophistication. It is therefore essential that industrial policy is coordinated and creates synergies with policies for science, technology and innovation (STI).

STI policy: To support and advance the process of structural transformation, LDCs’ technological capabilities need to be strengthened by reinforcing the absorptive capacity of their firms and farms. This includes strengthening their capacity to absorb and master superior technologies from more advanced countries (whether developed or developing). This, in turn, requires improvement in the international system for technology transfer to LDCs. Domestically, STI policies need to reinforce local and regional research and development, especially in agriculture, as well as to be coherent with education policy.

Finance: Transformative productive investment and technological upgrading are crucial to increase labour productivity within sectors and to promote productivity-enhancing structural change; and finance plays a key role in mobilizing resources, both domestic and foreign, and intermediating them effectively to these ends. Beyond the traditional banking sector, considerable opportunities for domestic resource mobilization are opening

up for LDCs through innovative financial instruments relying on the increasing penetration of information and communications technologies (ICTs), notably mobile banking and money transfer services.

Macroeconomic policies: Sound macroeconomic fundamentals are a necessary condition for the smooth working of the economy, but are not by themselves sufficient to spur structural transformation. Graduation with momentum requires considerable scaling up of capital accumulation; and fiscal policy has a key role to play in this context, notably through public investment that can crowd in additional private investment. Large-scale infrastructural projects addressing bottlenecks in productive sectors can achieve this, by relaxing supply-side constraints which hamper the private sector. Increasing the available fiscal space requires both improving taxation and revenue collection systems and diversifying public revenue sources. It also requires addressing the challenge of illicit financial flows, which besets fuel- and mineral-exporting countries in particular.

Employment generation: Graduation with momentum requires LDC economies to generate jobs on a substantially larger scale than in the recent past, to allow productive employment of the growing cohorts of new entrants to the labour market and thereby reap the demographic dividend. To reach these goals, the process of structural transformation should be steered so as to include the adoption of labour-intensive technologies, especially in sectors such as agriculture, manufacturing and infrastructure.

Gender: Structural transformation and development of productive capacities cannot be fully effective unless they empower women to develop their potential economic contribution to a much greater extent than at present. This requires gender considerations to be taken fully into account in all areas of policy. Such an approach could also be adopted in the formulation of the LDC criteria, where gender balance could become an additional component of the human assets index.

The international environment and international support measures

The international community has a central role to play in facilitating the path of LDCs to graduation with momentum. This means, first, ensuring a stable and conducive international economic environment; and second,

designing and implementing ISMs that contribute effectively to strengthening the process of graduation with momentum.

With respect to the first aspect, a major priority, the urgency of which UNCTAD has repeatedly emphasized, is to ensure a more conducive international financial system, to reduce the frequency of crises and ensure the financing of productive investment in both developed and developing countries, as well as to cater for the particular vulnerabilities and concerns of LDCs. A more supportive international environment, in the run-up to graduation and beyond, would also include strengthening regional integration and forging stronger trade and financial partnerships within the global South.

Similarly, UNCTAD has long stressed the importance of adopting measures to stabilize international commodity markets, for example through improvements in commodity market regulation. More predictable and less volatile commodity markets would facilitate the mobilization of resource rents for the development of productive capacities by reducing the uncertainty of LDC export revenues and the negative impact on current account balances of sharp fluctuations in terms of trade.

The current architecture of ISMs is not conducive to the achievement of the Sustainable Development Goals, especially in the LDCs. While the effectiveness of ISMs such as ODA and preferential market access has been eroded in recent years, the need for effective ISMs remains, particularly in view of the widening gap between LDCs and ODCs — a gap which is likely to widen further in the light of current trends. ISMs need to be designed to take into account both changing international conditions and the changing features and conditions of the LDC group.

In particular, development-financing practices need to be better suited to supporting structural transformation and resilience-building activities in both LDCs and recently graduated countries. ODA is the main source of external financing to LDCs, amounting to $47 per person and some 5 per cent of GNI on average in 2014. The Sustainable Development Goals and the IPoA objectives will thus not be fully achieved unless: (a) ODA to LDCs is increased at least sufficiently to meet the international target of 0.15–0.2 per cent of donor countries GNI; and (b) all donors allocate at least 50 per cent of net ODA to LDCs (as foreseen in paragraph 52 of the Addis Ababa Action Agenda). This is particularly important to those countries expected to make up the LDC group in 2025, which will need to benefit disproportionately from such increases in light of their underdevelopment and poverty. Therefore, the quantitative targets for ODA to LDCs should be kept intact even as the group

shrinks, in view of the greater needs of the remaining LDCs. Moreover, in line with the strategy of graduation with momentum and with the approach of the 2030 Agenda, donors would raise aid effectiveness by rebalancing their aid allocation towards supporting the development of productive capacities.

Blended finance, combining ODA, philanthropic funds and other public or private development finance flows, may offer a versatile means of mobilizing and leveraging private resources. Other financial instruments, such as GDP-indexed bonds, countercyclical loans and weather insurance, may also have a role to play in helping LDCs to manage risk and vulnerability to shocks more effectively.

An LDC finance facilitation mechanism: The proliferation of separate institutions and financing windows, together with limited progress towards donor coordination and harmonization, has given rise to an increasingly complex development finance architecture for LDCs. To improve their access to development (and, for example, climate) finance, this Report proposes the establishment of an LDC finance facilitation mechanism (FFM). The FFM could serve as a "one-stop shop", identifying appropriate funding agencies for the investments identified as priorities in LDCs' national development strategies by matching them with the particular criteria, priorities and preferences of potential funding sources. This could considerably reduce the administrative burden of seeking development finance, while accelerating access to finance and reducing funding uncertainty. Such benefits could be further enhanced by providing support to the preparation of funding applications and fulfilment of reporting requirements; and an appropriately designed FFM could also contribute substantially to capacity-building in LDCs. An appropriate structure and adequate funding and staffing would be essential to the effectiveness of such a mechanism. In view of its long-standing work on financing for development and on LDCs, UNCTAD could play a useful role as a member of the board of the FFM, which would decide its priorities, policies and practices.

Trade: In the area of trade, preferential market access is one of the most effective ISMs in favour of LDCs, even though not all countries have adopted DFQF schemes for LDCs, and the coverage of existing DFQF arrangements is incomplete. Achieving 100 per cent DFQF coverage would certainly represent an important step towards the IPoA/Sustainable Development Goal target of doubling LDCs' share in global exports. Equally, one of the priorities of a successful smooth transition strategy should be to ensure that graduating countries retain some degree of preferential access in key export markets through other unilateral preference schemes or bilateral or regional

agreements. From a longer-term perspective, however, the strategic value of preferential market access should not be overemphasized.

It is important that preference-granting partners review their rules of origin in accordance with the WTO Ministerial Decision on Preferential Rules of Origin for Least Developed Countries, originally adopted at the Bali Ministerial Conference in 2013 in the form of a "best endeavour" clause. It is also important to capitalize on the ongoing efforts to streamline non-tariff measures — especially in the field of agricultural goods — and to converge, to the extent possible, towards commonly accepted international standards, to reduce compliance costs.

Greater progress is needed towards operationalizing the LDC services waiver, to enable LDCs to take greater advantage of the expansion of international trade in services. Enhancing the commercial value of the preferences under the waiver and increasing the number of preference-granting countries could represent significant steps in favour of a number of LDCs, particularly island LDCs.

Technology: LDCs could harness more fully such policy space as is available to them through bolder and more strategic industrial policy frameworks including in the field of technology. Appropriate STI policy frameworks, for example, could help LDCs to reap some of the strategic opportunities offered by the extension of the transition period for their implementation of the TRIPS Agreement, particularly if combined with more effective support for technology transfer under its article 66.2.

The international framework will start to work for technology transfer, rather than focusing mainly on the protection of intellectual property, if developed countries comply with their obligation under article 66.2 of the TRIPS Agreement to foster technology transfer to LDCs. In order to reach this goal, the following measures could be considered.

- The WTO TRIPS Council could implement its 2003 decision to review the monitoring system for developed countries' compliance with their obligations under article 66.2. It could require developed countries to report, in a standard format, comparable information on programmes and policies relating to activities corresponding to a previously agreed definition of technology transfer. LDCs could play an active role by reporting on the extent to which technology transfer is contributing to their building a sound and viable technological base.
- Developed countries are advised to focus on sectors and activities where technology transfer is not profitable for technology owners

due to low absorptive capacity in the receiving country, and where technologies correspond to local entrepreneurial demands in LDCs, where they have a high social return.

- Institutionally, developed countries could consider funding specialized agents that link developed country donors, private firms holding a given technology and entrepreneurs in LDCs to ensure the effectiveness of technology transfer operations.

The United Nations Technology Bank can become an instrument to foster the development of technological capabilities of LDCs if:

- It has a monitoring mechanism that ensures that the ultimate objective of helping LDCs to build a solid and viable technological base is being achieved;
- It is adequately funded, especially as it expands its activities;
- It gives priority to the transfer of technology (including intellectual-property-free technologies); and
- It adjusts technical assistance to LDCs in the management of their intellectual property systems according to the type of system most appropriate to their level of economic and institutional development.

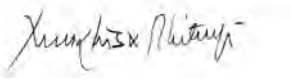
Inputs for reconsidering LDC criteria: The effectiveness of the current graduation criteria in capturing the extent to which LDCs have overcome the structural impediments to development is open to debate. Particular issues are raised by the potential for LDCs to graduate without having advanced in structural transformation and the failure of any LDC graduate to date to achieve the graduation threshold for the EVI — arguably the most suitable of the three criteria to capture structural vulnerabilities.

Such issues have given rise to calls for revisions of the criteria and graduation thresholds used to define the LDC category. Issues which the CDP might consider in this context include:

- Incorporation, to the extent possible, of the Sustainable Development Goals and the 2030 Agenda;
- Incorporation of the perspective of graduation with momentum, so as to embed graduation in a long-term process of sustainable development;
- Enhanced measurement of structural transformation;
- Enhanced environmental criteria, including consideration of climate change and related vulnerabilities.

More specific approaches which the CDP might consider include the following:

- *A "vulnerability ceiling":* In addition to satisfying the existing criteria, a graduating country could be required to have an EVI of no more than half of the graduation threshold level;
- *Adjustment of the composition and computation of the EVI:* The exposure index could be improved by giving less weight to geographical challenges, such as size and remoteness, and more to those reflecting structural transformation and environmental considerations; replacing the share of agriculture, fisheries and forestry in production with a composite index of structural transformation; and replacing the environmental subindex with one or more indices better reflecting LDCs' particular environmental concerns and vulnerabilities, particularly those related to climate change; and
- *Separate indices:* A more far-reaching proposal, in line with the concept of graduation with momentum, would be to separate the structural transformation and environmental dimensions and build separate indices. The structural transformation index could also be made a mandatory condition for graduation.



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