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High-Level Interactive Thematic Debate

Concept Note

Title: ENHANCING PRODUCTIVE CAPACITIES AND THE ROLE OF THE PRIVATE SECTOR IN LDCS

Date: Monday 9 May 2011
Time: 3:00 pm to 6:00 pm
Venue: Camlica Hall, ICC

Introduction

LDC economies suffer from limited productive capacities and structural weaknesses which impede their growth prospects and constrain their ability to produce efficiently and competitively. For LDCs, the development of productive capacities in agriculture, in manufacturing and in the services sector, and the redeployment of resources into dynamic activities with higher productivity therefore lie at the heart of self-sustaining and lasting economic growth.

Productive capacities are developed through investments in physical and human capital, social and environmental capital, and through technological acquisition and innovation. The process results in the diversification of national economies, structural transformation and a more beneficial integration into the global economy, and these changes themselves facilitate the potential for further investment and innovation in a virtuous circle.

While the private sector is the main driver of this process, in LDCs it is largely dominated by small and informal enterprises which are constrained by a lack of resources and capacity. For this reason, they will require public support. The provision of public goods and infrastructure in particular, and the facilitation of diversification are broad roles governments have to play even in a market-based approach. Development partners can play a supportive role in this regard, for example through the provision of Aid for Trade to productive capacity building.

Moreover, interventions have to be embedded in a broader national development strategy and a supportive macroeconomic framework. The latter will also ensure that productivity growth is accompanied by increases in demand. In addition to exports, dynamic domestic demand is a necessary requirement for equitable and balanced growth. Due to their small size, LDCs will often rely on regional integration to achieve dynamic and self-sustaining growth.

Productive capacity development thus requires an integrated policy approach, encompassing national policies, international policies and South-South development cooperation. LDCs themselves should take the lead in devising targeted national policies, and they need to be vigorously backed up with enhanced international support mechanisms and development-friendly global economic regimes.

Situational Analysis

The period since the adoption of the 2001 Brussels Programme of Action on the LDCs has seen a strong acceleration in economic growth, according to the Secretary-General's report on the ten year appraisal of the BPoA [A/66/66–E/2011/78]. During 2002-2007, growth of real gross domestic product (GDP) surpassed the 7 per cent per annum target set in Brussels in some LDCs, a marked improvement over the previous decade's average growth rate of below 4 per cent. Even in the aftermath of the global financial crisis, LDCs continued to grow at rates above global averages.

Evidence points, however, to the large role played by oil and other raw commodities in growth, and that neither employment rates nor poverty reduction in the LDCs have advanced apace. LDCs have only made slow progress in developing their productive capacities and achieving structural transformation of their economies, a central goal of the Brussels Programme of Action. The share of manufacturing in GDP has only increased slightly in the last decade and stood at 12.5 percent in 2009, as compared to 10.4 percent in 2000 and 11.2 percent in 1980. What is more, much of this modest growth has been driven by Asian LDCs and African oil exporters, while many non-oil exporting LDCs have actually seen their manufacturing sector recede further.

Low productivity has also hampered progress in the agricultural sector. The weak growth of agricultural labour productivity is closely linked to population growth, a shrinking of plot sizes and an increasing reliance on marginal lands. As a result, farmers were largely unable to benefit from food price hikes in 2007 and 2008 and investment and output did not increase significantly in LDCs. On the other hand, the services sector has gained in importance; however the effects of this expansion on the broader economy vary substantially.

Major Challenges facing LDCs

The challenges LDCs face have thus remained largely unchanged in the last decade. Weak productive capacities manifest themselves in low agricultural and manufacturing productivity and a poorly developed services sector, a continued dependency on resource exports, a lack of diversification, and a weak private sector dominated by informal and small enterprises.

Insufficient infrastructure is consistently ranked as one of the most important impediments to more private investment by entrepreneurs in developing countries. In rural areas, the lack of irrigation systems and high transportation costs are major reasons for low agricultural productivity. The manufacturing sector and industry critically depend on power supply and reliable access to energy, water, and transportation and communications infrastructure. Yet, evidence suggests that infrastructure investments in most LDCs are low, and trail those of fast growing economies such as China, Thailand and Viet Nam. Progress has therefore been sketchy. Total road network expanded in 13 least developed countries, but declined in 5. Air and rail links have not advanced decisively either. Most LDCs continue to experience frequent power outages, severely crippling the ability to meet public needs and attract investment.

In addition to physical infrastructure, human capital development through education, training and skills development is critical to improving productive capacities. In this regard, LDCs should be able to benefit from a demographic bonus: their young and dynamic workforce which represents a key resource for LDCs. The human and social development of these young people is essential to build and sustain longer-term productive capacity of a country. Without sufficient productive and remunerative employment, the large youth population could actually become a liability. Historically, social development accompanied industrialization and economic development in most countries. In the 'late industrializers', social investment was an integral part of the modernization processes, nation building, and productive development.

Diversification into higher-value added products with growing demand has been very limited in LDCs. Yet, the diversity of manufacturing production and the level of sophistication of products are main determinants of a country's growth performance. So far, LDCs have largely failed to achieve this structural transformation. Reliance on market mechanisms has proven to be insufficient, as small and informal enterprises lack the capacity and markets alone are incapable of providing the necessary incentives to engage in new economic activities. For this reason, fast growing developing countries historically have used industrial policies to address market failures, and to overcome coordination failures and externalities. Specifically, they have targeted sectors for rapid development, and have coordinated the respective technology acquisition decisions across firms, allocated concessional credit for inherently risky new activities, provided temporary and conditional protection to allow for learning, and provided targeted infrastructure. Through these policies, they have fostered the investment-profit nexus, expanding private profits as an incentive for investment, a source of investment and outcome of investment.

While the theoretical case for implementing industrial policies is sound, they are associated with costs and bear significant risks, particularly in light of capacity gaps and resource constraints in LDCs. It is therefore crucial that governments closely cooperate with the private sector, embed their industrial policy in their broader national development strategies, and prioritize their interventions, focusing on sectors or activities where lead firms are willing to engage, and have linkages with or require productive capacities resembling those of activities already in place.

Lastly, the development of productive capacities has to be cognisant of demand. LDCs are disadvantaged by small domestic markets, so an expansion thereof, for example by increasing agricultural productivity and rural incomes, would provide a much needed boost for local firms and can trigger self-sustained and reinforcing growth. Similarly, sectoral priorities set in national development strategies should take current and future demand into account, targeting more dynamic higher value adding sectors for both domestic and global markets. The Aid-for-Trade Initiative was launched to address exactly these concerns. The Enhanced Integrated Framework allows LDCs to express their priorities and needs for trade-related assistance and capacity building.

Policy Measures by both LDCs and Development Partners

The key objective for LDCs in the next decade is to build their productive capacities to achieve structural transformation, through (i) infrastructures especially those related to the productive use of energy, (ii) technology, innovation and learning, (iii) sound industrial policies and sectoral strategies, and (iv) balanced and inclusive growth.

LDCs differ with respect to their economic structures, needs and priorities. The development of productive capacities therefore is a country-specific process. LDCs therefore have to identify their own priorities in terms of sectors (outputs) and ingredients (inputs). To achieve their objectives and to build the relevant productive capacities, LDCs and their development partners have to ensure that the productive-capacity development agenda is mainstreamed into policies and strategies related to agriculture, industry and the services sector, and into the programmatic activities of development partners. In addition, productive capacity development mainstreaming has to be accompanied by corresponding spending increases by LDCs and development partners.

Infrastructure

- Infrastructure investments are a major pillar of productive capacity development. Both governments and development partners should increase their share of infrastructure expenditure and target investments in priority areas and sectors as defined in national development strategies. Infrastructure investments encompass transport, ICT, energy and ports.
- ICT facilitates progress in sectors such as trade and productive capacities, but also in environment, disaster risk management, health, and agriculture. While mobile technologies have gone a long way in bridging the digital divide in LDCs, access to broadband, particularly in rural areas, needs to be addressed.
- While sectoral priorities will vary across LDCs, investments in rural infrastructure are particularly important to increase agricultural productivity and raise incomes of the rural poor, and will contribute to increasing food security.
- The lack of energy security, i.e. energy access for productive use and efficient management of energy use, impede the productive sector's capacity to drive growth and diversification. In order to put LDCs on an environmentally sustainable growth path, LDCs and development partners need to pursue innovative, smart and locally relevant energy solutions.
- Aid has been provided increasingly for social uses in the last three decades, and the share going to production sectors and economic infrastructure has declined. Providing more aid for the development of productive capacities will result in a closer alignment of ODA with the LDCs' development priorities. In this regard, Aid for Trade plays a crucial role. Support for trade-related infrastructure support in LDCs reached almost US$ 7 billion in 2009.
- LDCs and their development partners also need to mobilize resources from the private sector to maintain and upgrade infrastructure and to improve efficiency. To this end, LDCs have to create an enabling policy and regulatory framework, while development partners should adapt their investment policies to encourage public-private partnerships and private sector investments. At the same time, investments should be steered to sectors the country deems desirable. Currently, the bulk of FDI is aimed at extracting industries, with limited benefits for the broader economy.
- Infrastructure development will benefit from the transfer of appropriate and affordable technology, and should focus on innovative and practical solutions, particularly in the field of clean and renewable energy.
- Lastly, both LDCs and development partners should promote regional cooperation in infrastructure such as transport corridors and power pools through regional harmonization of regulatory standards and the pooling of resources. Regional approaches to infrastructure development are advisable since the indivisibility of infrastructure and the massive financing needs for investing in infrastructure can often not be dealt with on a national scale.

Technology, Innovation and Learning

- LDCs and their development partners can support technology acquisition and innovation through a variety of measures.
- LDCs should promote investments in innovation, and scale up "game changers" for development such as weather-resistant seed varieties, low-cost water treatment systems and ICT innovations.
- Together with development partners, they should support local research and development, targeting existing technologies, and strengthen the respective institutions.
- Technology transfer and developing technological absorptive capacity are of equal importance. Article 66.2 obliges developed countries to provide incentives to their enterprises to promote and encourage transfer of technology to LDCs and help establish a sound and viable technological capability. However, studies show scant evidence of adequate implementation.

- A Technology Bank for LDCs, jointly administered by LDCs and development partners, would facilitate access to critical technology in agriculture, renewable energy, infrastructure and other sectors.
- At the enterprise level, the few firms in the “missing middle” of the enterprise structure in LDCs need a policy, financing and institutional framework that enables them to contribute to innovation. Internationally financed national technology/innovation funds such as proposed in the International Spark initiative by UNCTAD could be a way for the international community to address these issues.
- Lastly, human resource development through education, training and skills development, including in primary, secondary and teachers’ education, will contribute to productivity growth and to increasing a country’s absorptive capacity.
- Skills development should take into account broader sectoral priorities. Vocational training must also be a key component of the LDCs’ education system particularly in the areas of maintenance and repair in order to promote scientific skills among the youth.

Industrial Policies and Sectoral Priorities

- Agriculture remains the largest provider of employment to the majority of LDCs. The sector’s importance has been further highlighted by the recent food crisis. Agro industries and agribusiness development is thus a key priority for LDCs, with particular focus given to food and food processing products.
- To increase food availability and nutrition and raise rural incomes, Malawi has successfully subsidized fertilisers and seeds for a large number of beneficiaries, significantly increasing national maize production and productivity. This is an example of creative government support responding to a specific bottleneck (high input prices) hampering productivity.
- In agriculture as in other sectors targeted for support, discussions with key stakeholders are crucial to identify bottlenecks that prevent existing farmers/ SMEs from upgrading. In light of resource constraints, sectoral strategies in LDCs need to be based on activities that already exist. Interventions should focus on increasing their output and productivity, move them into higher value-added products and use them as lead sectors to build competitiveness in upstream and downstream activities.
- In their support to the private sector, governments should engage in Competitiveness Partnerships, which bring together lead firms, intermediate SMEs that provide inputs, and foundation providers such as financial institutions. Such partnerships will strengthen clusters and foster network creation.
- Specifically, enterprises need to be provided with better access to credit and Mutual Credit Guarantee Schemes, streamlined administrative and bureaucratic procedures for business registration and licensing, and technical assistance programmes for quality upgrading and creation of regional laboratories for conformity assessment.

Balanced and Sustainable Growth

- LDCs should promote a virtuous cycle between rising demand and productive capacity building to help them break out of a low-equilibrium trap and reduce dependence on a very limited number of export products.
- To achieve self-sustaining growth, national policies to develop productive capacities have to be accompanied by growth-oriented macro-economic policies that target employment creation.
- In addition, economic and social policies must be considered in a complementary and mutually-reinforcing manner, using an integrated approach that acknowledges that investing in people’s

capabilities – their education, health, social protection, food security, nutrition, etc. – contributes to productivity, sustainability and economic growth.

- Against the background of high population growth, poverty reduction efforts will further increase pressures on natural resources, including water, land, forests and the climate. Sustainable growth therefore requires that LDCs take measures to encourage more sustainable agricultural and industrial production, and that LDCs address population dynamics.
- The small size of the domestic markets calls for a regional approach – encompassing regional trade integration and a regional approach to productive capacity development.
- With regards to exports, the main goal for LDCs is to achieve more diversification, and to export goods with higher added value and higher technological content. To this end, market access for LDC products needs to be enhanced, particularly in emerging market economies.
- Aid for Trade can support increased and efficient production by helping to identify and remove supply side constraints and by strengthening trade-related infrastructure in order to match regional and global supply and demand more efficiently. At the same time, Aid for Trade can assist in connecting markets, facilitating distribution, and providing storage and improving standards and quality.
- The Enhanced Integrated Framework's (EIF) Diagnostic Trade Integration Studies set out a country's nationally agreed priority areas and provide a common platform for government, civil society, private sector and development partner stakeholders to own the trade and development track a country is moving down. The EIF also serves as a platform for LDCs and donors to meet to generate additional funding over and above that available in EIFs own Trust Fund.