

## UNLDC IV

# Productive capacity development for structural transformation of LDCs

Dr Mohammad A. Razaque

**Economic development** implies a country's progress from primary and traditional activities to more productive manufacturing and modern services sectors. In a majority of the least-developed countries (LDCs), such a transformation mechanism has largely been absent due to the lack of adequate productive capacities.

This paper argues that the primary focus of developing productive capacities in the LDCs should be for their structural transformation. LDCs should be mindful that overlooking the issue of linking productive capacities with structural transformation may not deliver medium to longer term growth and development objectives.

While focusing on structural transformation, LDCs need to be more strategic in seeking support from the international development community. Their participation in the Fourth United Nations Conference on the Least Developed Countries (UNLDC IV) gives them a good opportunity in seeking such support.

Having recognized the special challenges and needs of the least-developed countries (LDCs), the United Nations, since the 1980s, has been hosting the United Nations Conference on the Least Developed Countries (UNLDC) once every decade with a view to helping LDCs devise suitable responses. Backed by the support of the international development community, the previous three conferences (held in 1981 and 1991 in Paris, and in 2001 in Brussels) adopted three Programmes of Action outlining the goals and objectives to be pursued and strategies and acts to be put together both at country and global levels. As the stage for UNLDC IV is now well set in Istanbul, Turkey, assessment of the progress made on the Brussels Programme of Action and lessons to be drawn for better implementation of what is likely to be called the Istanbul Programme of Action (2011–2020) currently take centre-stage in the international development policy discourse on LDCs.

The preparatory processes and pre-Istanbul conferences have focused on a variety of issues—both longstanding as well as emerging—that are considered to have important developmental implications. These include, *inter alia*, international trade, overseas development assistance (ODA), foreign direct investment, transfer of technology, governance, climate change, food security and South-South cooperation.

One of the key themes surrounding these issues has been the development of productive capacities in LDCs.

## PRODUCTIVE CAPACITY

Lack of productive capacity has been singled out as the most important constraint facing LDCs. To put things into perspective, with a total population of 837 million, the combined merchandise exports from 49 LDCs in 2008 stood at about US\$180 billion, which is lower than what Malaysia, a country of 27.8 million people, exported in the same year. Similarly, annual production in LDCs, as measured by gross domestic product (GDP), is estimated at US\$552 billion, which is just about the same size of a 38 million-strong Polish economy.

The concept of productive capacity is easy to perceive but difficult to define. According to the United Nations Conference on Trade and Development (UNCTAD), productive capacities include physical and human resources, entrepreneurial capabilities, and productive linkages, which together determine the capacity of a country to produce goods and services. This definition is broad and does not make any distinction between sectors. Infrastructural development, accumulation of factors of production in agriculture, industry, and services sectors, and enhancement of productivity all contribute to productive capacities.

LDCs have limited productive capacities and they also suffer from lack of economic diversification. While economic development would imply a country's progress from primary and traditional activities to more productive manufacturing and modern services sectors, in an overwhelming majority of LDCs, such a transformation mechanism has largely been absent. For instance, during the 2000s, LDCs demonstrated a remarkable economic performance recording an average annual GDP growth of 7 percent. However, this has not been translated into an improved relative significance of manufacturing activities. Actually, the share of manufacturing in LDCs' GDP fell to 9.8 percent in 2008 from 10.6 percent in 1990. The manufacturing-GDP ratio in 36 LDCs in 2008 was less than 10 percent; in 24 LDCs this ratio in 2008 was lower than that in 1980.

The rather remarkable performance of LDCs' merchandise exports growing from as little as US\$36 billion in 2000 to US\$178 billion in 2008 is greatly overshadowed by the fact that commodities and natural resource-based products have been the overwhelming driver of this growth. Primary commodities and fuels

accounted for about 81 percent of LDC exports in 2008—up from 51 percent in 2000. The share of manufacturing exports actually fell from 29 percent to 19 percent during the period. On an index of export diversification, which compares an individual country's export structure to the world average, ranging from a value of 0 (highly diversified and reflecting the world average) to 1 (highly concentrated and being far away from the world average), the LDC export basket is positioned at 0.71 as against 0.22 for developing countries as a group. For almost 75 percent of LDCs, the estimated index value is more than 0.7. Therefore, both domestic production and export structures vividly portray the challenges of achieving structural transformation in LDCs.

## STRUCTURAL TRANSFORMATION: LESSONS FROM RECENT RESEARCH

It is important to provide a special focus on structural transformation while considering the development of productive capacities in LDCs. When the objective is defined in terms of structural transformation, there will be important policy issues to consider with further implications bearing upon the international support regime that Istanbul is likely to offer.

Recent cutting-edge research has provided important insights into the process of structural transformation and its implications for policy. Empirical assessments have demonstrated that what countries export and how they specialize matter for their future growth, and economic development requires diversification and not specialization as such.<sup>1</sup> In a ground-breaking research, a team of experts has shown that countries' initial specialization does influence structural transformation and countries that have specialized in such areas as minerals and natural resource-based products will find it difficult to diversify.<sup>2</sup> Using product-specific export data for a large number of countries, these researchers have constructed a network of the relatedness between products, shedding light on the question why some

“ What countries export and how they specialize matter for their future growth, and economic development requires diversification and not specialization as such. ”

countries have been successful in expanding their product lines whereas others struggle to do so. The structure of the product space is such that more sophisticated products (e.g., metal, machinery, and chemicals) form the core, and have linkages with many other products. Quite away from the hub, products like garments, textiles, and electronics are found to have their own clusters, which have lower linkages than the items in the core. However, products of export interest to a vast majority of LDCs—e.g., tropical agriculture, fishing, mining and oil, forest products, cereals and coffee—are situated almost in isolation in the network's periphery.

Since countries can move relatively easily through the product space by developing goods similar to those they already produce, LDCs find it difficult to extend their product variety. While Chile and South Korea, for example, had similar levels of production and export sophistication, South Korea could extend its sophisticated product lines faster than Chile since it produced some core products. Also, as Malaysia invested in microchips and electronics, it could situate itself closer towards the core of the product space, creating opportunities for product development in other areas. For LDCs, therefore, an important lesson is: while countries in close proximity to other products can benefit from a natural structural transformation, countries far away from the core (i.e., at the periphery and being involved in primary production) would need to make much "longer jumps" to get engaged in activities with significant linkages.

## IMPLICATIONS FOR LDCs

These findings are crucial in understanding better the more fundamental challenges associated with productive capacity development leading to structural transformation and sustained growth and development. First, let us consider the clear-cut implications for trade and industrial policy. Given LDCs' initial specialization and static comparative advantage, mere accumulation of resources (or, overall enhanced productive capacity) would tend to be concentrated around primary activities, which are unlikely to trigger diversification. As commodity price booms reinforce the existing static comparative advantage, breaking into dynamic sectors in the absence of a proactive policy initiative would be even more difficult. On the other hand, the findings of the product space research do not lend support to the old-school import-substitution strategy either. Providing across-the-board policy support would not be of much help as only a few realistically targeted

“ While putting forth their demand for technology transfer, LDCs should be specific about those technologies that would help them achieve economic diversification. ”

sectors hold the promise of opening up further linkages. With this major change in approach, there is now a more persuasive justification for trade and industrial policy than the traditional infant industry argument. One significant outcome of the product-space mapping is that existing factors of production do not matter in predicting how diversification can succeed, providing policies a much bigger role to play than has been appreciated by orthodox development practitioners.<sup>3</sup>

When structural transformation is to be given prominence, LDCs need to be more strategic in seeking support from the international development community. For example, restrictions (both tariffs and non-tariff barriers such as rules of origin, compliance related measures, etc.) in a few products could be disproportionately damaging if the left-out sectors have the potential for helping poor countries break into dynamic sectors. This is particularly true for preferences received from emerging developing countries as they are usually marked by significant exceptions. Since LDCs are predominantly commodity exporters, market access alone in large developing countries may not help in LDCs' transformation. Similarly, LDCs' demand for technology transfer has been broad and general in nature. They have been asking developed countries to increase incentives to their enterprises for the purpose of promoting and encouraging technology transfer. While putting forth their demand for technology transfer, LDCs should be specific about those technologies that would help them achieve economic diversification.

Increased ODA has been a major demand of LDCs. However, in light of the above discussion, a more fundamental implementation-related issue is whether they will have the policy space to decide about the use of such increased resources in certain sectors. Aid for trade (AFT), a component of ODA, has recently received much attention in recognition of its potential in enhancing export supply response from LDCs. However, availability of AFT resources alone would not

help determine whether the existing specialization in the economy is appropriate in aiding manufacturing activities. In a largely agrarian economy, construction of bridges and road networks (i.e., enhancement of productive capacities) are likely to promote primary exports. This is certainly an important development, but in itself might not result in adding dynamic products to the country's export basket.<sup>4</sup>

Along with ODA and other sources of foreign capital, some LDCs are currently benefitting from the historic commodity price booms, with many experts suggesting such a trend to continue in the foreseeable future.<sup>5</sup> This should provide an opportunity for commodity-exporting LDCs to generate resources for developing their dynamic sectors that can lead to structural changes.

## WAY FORWARD

Even when the importance of structural transformation is duly acknowledged, identification of the sectors for support may be an involved task, and policymakers may not have adequate knowledge to pick the winners. In this regard, the product space approach can act as an important analytical tool by suggesting the priority sectors based on proximity and linkages. Despite the newly-found support for trade and industrial policy, its proponents exercise caution over suggesting public policy options. Particularly, it is emphasized that an indiscriminate use of policy instruments and direct involvement of the government in business could have serious consequences. Policy support needs to be carefully designed and it may be helpful to have a proactive government role to help coordinate the accumulation of capabilities with respect to the targeted sectors.

As they prepare to participate in UNLDC IV, LDCs should bear in mind that while enhancing overall productive capacities is important, overlooking the issue of linking it to structural transformation may not deliver medium to longer term growth and development objectives. With the emergence of a new analytical thinking, and in the aftermath of a catastrophic global financial crisis, there has been a renewed focus on the role of state in development. This can actually assist LDC policymakers in making use of their existing policy space to execute a well-designed proactive role to transform their economies.

Economist Dani Rodrik astutely observes that successful countries have always pushed the limits of their static

comparative advantage and diversified into new activities that are the domain of countries considerably richer than they are. This should be considered as an important lesson for LDCs while considering the development of their productive capacities. ■

## NOTES

- <sup>1</sup> An excellent discussion on this is covered in Rodrik, D. 2006. "Industrial development: Stylized facts and policies". <http://www.ksg.harvard.edu/rodrik/>. Also see Hausmann, R., J. Hwang, and D. Rodrik. 2005. "What you export matters". NBER Working Paper W11905.
- <sup>2</sup> Hidalgo, C. A., B. Klinger, A.-L. Barabási, and R. Hausmann. 2007. "The product space conditions the development of nations". *Science*, Vol. 317, 27 July 2007.
- <sup>3</sup> Useful discussions without technical details on this can be found in "Can network theory explain why some developing countries stay poor?" at [www.sciencewriter.org](http://www.sciencewriter.org).
- <sup>4</sup> There is now some evidence that while AFT has contributed to rising export revenues in developing countries, such a positive effect of aid for productive capacity is not clear. Details can be found in various Commonwealth Secretariat studies, a summary of which can be found in a WTO document, WT/COMTD/AFT/W/25, at [www.wto.org](http://www.wto.org).
- <sup>5</sup> For example, see Collier, P. 2011. *Catching up: What LDCs can do and how others can help*. London: Commonwealth Secretariat.



© SAWTEE, 2011

The author is Economic Adviser (International Trade & Regional Cooperation), Commonwealth Secretariat, London. This is a publication under SAWTEE's Regional Programme "Trade, Climate Change and Food Security". The programme is supported by Oxfam Novib, The Netherlands.

Views expressed are of the author and do not necessarily reflect the position of the Commonwealth Secretariat, SAWTEE or its member institutions.

## ABOUT US

South Asia Watch on Trade, Economics and Environment (SAWTEE) is a regional network that operates through its secretariat in Kathmandu and member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The goal of SAWTEE is to enable stakeholders, particularly the poor and marginalized, to derive net benefits from changing political economy and environmental landscapes.