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Globalization and the Least Developed Countries: Issues in Trade and Investment

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GLOBALIZATION AND THE LEAST DEVELOPED COUNTRIES: ISSUES IN TRADE AND INVESTMENT[1]

∞ Introduction

Globalization has been associated with rising world income. Many countries and people have benefited from this, but some countries and people have been left out. Amongst the latter are many Least Developed Countries (LDCs), and a relatively large share of the population of the LDCs. Many LDCs have been marginalized in the world economy although they have undertaken far-reaching economic reforms.

In the past decades, many LDCs have pursued extensive liberalization and today have relatively open trade regimes. The considerable trade liberalization of LDCs is sometimes overlooked as LDCs have typically pursued trade liberalization in the context of structural adjustment programmes rather than multilateral trade negotiations. Today, the central question for LDCs is not so much how they may achieve a further liberalization of their trade regime; rather it is how they can effectively promote development with a relatively open trade regime.

This paper argues that while each country will need to identify a "post-liberal development strategy" that is most suitable to its particular circumstances, the various "post-liberal development strategies" are likely to have common features regardless of the specific context[2]. In particular, regardless of country context, they should include a shift in focus from trade-led development to development-led trade, with a complementary broadening focus from supply-side capacities to productive and economic growth capacities at the national level. At the international level, it is important to look beyond further trade liberalization to strengthening the export capacity and performance of LDCs in a sustainable manner and ensuring effective market access.

∞ The impact of past reforms and the challenges ahead

The majority of LDCs have participated extensively and intensively in structural adjustment reform programmes. According to a recent World Bank study many low-income countries, including LDCs, have sound macroeconomic policies in place[3], and according to the IMF index of trade restrictiveness, many low-income countries, including LDCs, have relatively open trade regimes. Despite decades of reform, the LDCs remain marginalized in the world economy. While some LDCs, mostly in Asia, have managed to increase their share in world trade and income, and have also managed to reduce their high incidence of extreme poverty, most LDCs – mainly in Africa – have seen decreasing shares in world trade and income, and increasing incidence of extreme poverty[4]. The trends that can be observed for the different groups of LDCs, based on their geographic location, are closely related with trends that can be observed for different groups of LDCs classified by their export specialization. The Asian LDCs that have done better have typically managed to diversify into manufactures and/ or services while the African LDCs which have done less well continue to specialize in non-oil primary commodities[5].

[1] This issues paper was prepared for the Ministerial Conference "Making Globalization Work for the LDCs", Istanbul, Turkey, July 9-11, 2007 by the Division for Africa, Least Developed Countries and Special Programmes (ALDC) United Nations Conference on Trade and Development (UNCTAD) Geneva, Switzerland. The paper is based on UNCTAD (2004 and 2006) and includes significant inputs from the Inclusive Globalization Cluster of the Poverty Group in UNDP's Bureau for Development Policy. Comments were provided by staff in the Office of Development Studies of UNDP and by the Executive Office of UNDP. Issues raised by UNDP Country Offices have also been included as appropriate.
[2] UNCTAD, 2004, pp.282-283.
[3] World Bank, 2002.
[4] Karshenas, 2001.
[5] UNCTAD, 2002, pp. 49-61, 124.

Despite reforms, LDCs remain marginalized in the world economy

In the thirty-year period between 1960 and 1999, the income gap between the world's 20 richest countries and the LDCs continued to widen[6]. Weighted by population, the average income per capita of the 20 richest countries was about 16 times as high as that of non-oil commodity exporting LDCs in 1960, while it was 35 times as high by 1999. As such, this gap more than doubled by 1999. By contrast, the income per capita of the 20 richest countries was 8 times as high as that of manufactures and/ or services exporting LDCs in 1960 and 12 times higher than that of this subgroup of LDCs in 1999. While the income gap between the richest countries and all LDCs continued to increase, the gap with non-oil commodity exporting LDCs increased at a much more rapid pace by the late 1990s compared with the income gap between the richest countries and manufactures and/ or services exporting LDCs, which increased by much less[7].

A similar difference between the LDCs can be observed with regard to poverty incidence[8]. While LDCs that continue to specialize in non-oil commodities have seen an increase of extreme poverty in the past decades, the LDCs that specialize in manufacturing have seen a decrease of extreme poverty. Between the late 1980s and the late 1990s, extreme poverty in non-oil commodity exporting LDCs rose from 67 percent to 69 percent, an increase from the early 1980s, but it fell in manufacture exporting LDCs (even if Bangladesh is excluded) from 48 percent to 44 percent[9]. The unfavourable poverty trends are particularly pronounced in LDCs which specialize in extractive industries, and the positive poverty trends are particularly pronounced in Bangladesh which has successfully increased its specialization in low-tech manufactures. Incidence of extreme poverty between the late 1980s and late 1990s also increased in LDC exporters of services from 41 percent to 43 percent[10]. If past trends persist, extreme poverty in the LDCs will increase rather than decrease in the coming decades. While the developing world as a whole is on track to achieve the objective of reducing extreme poverty by half between the base year 1990 and the target year 2015, the group of LDCs as a whole will not achieve this objective[11].

Because of these trends, policy makers in LDCs are concerned that they should be better integrated in world trade, that their share of world trade should be larger, and that they should manage to sustainably reduce the incidence of extreme poverty. In this context, recent literature has placed great emphasis on further trade liberalization[12]. It is argued that a further liberalization of trade will increase trade flows, that this will stimulate growth, and that higher rates of economic growth will reduce poverty. However, empirical evidence shows that past trade liberalization had ambiguous effects on growth and poverty reduction in the LDCs, and that further trade liberalization is unlikely to bring about the desired effects on growth and poverty reduction without a strong complementary policy package that changes the direction of development[13].

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[6] UNCTAD estimates based on Summers and Heston International Comparison Programme and World Bank, *World Development Indicators 2001,* CD ROM (UNCTAD, 2002, pp. 122-123). The income gap is the ratio of the weighted by population average GDP per capita (in 1985 PPP dollars) in the world's 20 richest countries to that in the LDCs and LDC subgroups. The sample of the world's 20 richest countries varies over time.

[7] UNCTAD, 2002, p. 123.

[8] There is a lack of poverty data for the LDCs that makes it difficult to monitor poverty trends in these countries. The most comprehensive and latest figures on the incidence and depth of poverty in the LDCs are derived from UNCTAD's *The Least Developed Countries Report 2002* database (for further references and methodological notes, see UNCTAD 2002, pp. 39-100, particularly pp. 62-64). While this paucity of data is very unfortunate, and has been highlighted by UNCTAD on various occasions (LDC Report 2002, LDC Report 2004 and background papers to both reports), very little had been done to rectify this lacuna till very recently. UNCTAD is now seeking to update its poverty estimates. This paper will be updated with the new data once this is available and before it is finally published after the Istanbul Conference.

[9] Using the same poverty estimate and including Bangladesh, poverty in manufacture exporting LDCs fell from 28 percent to 25 percent during the same period. UNCTAD, 2002, Chart 36 "The incidence of poverty in LDCs grouped according to export specialization, 1981-1983, 1987-1989 and 1997-1999" based on a $1 per day poverty line, p. 124.

[10] Ibid.

[11] UNCTAD, 2002, pp. 124.

[12] See Sachs and Warner, 1995; Dollar and Kraay, 2000.

[13] See Rodriguez and Rodrik, 2001; Helleiner, 2000; Helleiner, 1994.

Non-Tariff trade barriers, commodity dependence and phase-out of trade preferences

Today, tariff barriers to trade affect fewer LDC exports than non-tariff barriers to trade. In 1999-2001 environment-related trade barriers affected 20 percent of the merchandise exports of other developing countries, but no less than 41 percent of the merchandise exports of LDCs.

In the same period, 28 percent of LDC exports suffered from commodity price decline, compared with 15 percent in other developing countries. More recently, however, the resurgence of global commodity prices has helped lift many commodity-dependent countries out of a prolonged period of economic stagnation. This is partly due to increased demand for commodity exports from the LDCs in the most dynamic developing economies, particularly China and India. Strong demand for raw materials from these countries has had a remarkable impact on commodity prices and volumes of trade. For instance, there has been a considerable improvement in the terms of trade of sub-Saharan African countries (some 30 percent) between 1999 and 2004, far higher than in any other region[14]. Also, the trade volume of rice was up 67.5 percent in the decade between 1993-1995 and 2003-2005, while cotton increased by 48.8 percent, fresh and chilled vegetables by 69.7 percent, and cut flowers by 72.9 percent during the same period[15]. Nevertheless, such price increases do not cover all commodities and their real magnitude has been diminished by exchange rate movements, especially the US dollar. Furthermore, while markets are likely to remain buoyant in the medium term, the secular trend of declining real commodity prices may eventually reassert itself. Price movements, moreover, are not the only disadvantage for countries specialized in commodities, since commodity production is not associated with the technological externalities and 'learning by doing' which characterizes much of manufacturing and the technology-oriented service industries. The challenge for these countries is to sustain or accelerate the growth momentum over the coming years by gaining ground in more knowledge based activities whilst simultaneously upgrading the quality of their commodity production[16].

Furthermore, LDCs, more than other developing countries, are affected by challenges associated with the specialization in extractive industries, and LDCs, more than other developing countries, are negatively affected by the phasing-out of preferences on textiles and clothing[17]. While the EU has essentially compensated both African and Asian LDCs for phasing-out market access preferences in textiles through the introduction of wider GSP preferences (i.e., EBA), the US has compensated only African LDCs for the phasing-out of market access preferences with the introduction of wider GSP preferences (i.e., AGOA). Market access to the US has thus eroded for many Asian LDCs, especially in textiles and clothing. This affects some of the largest exporters of textiles and clothing amongst the LDCs[18]. Bangladesh's export oriented ready-made garment (RMG) exports account for 76 percent of total export earnings; the US is the destination of 42 per cent of RMG, yet clothing is excluded from the GSP. Furthermore, Nepal is deprived from the US duty-free quota-free treatment to apparel, which is a major export product to overseas markets[19].

Implications for trade policies: from trade-led development to development-led trade

Though the relationship between trade and development is the subject of contentious debate in the literature, there is little doubt that trade can be a powerful source of economic growth. International trade can expand markets, facilitate competition and disseminate knowledge which can catalyze economic growth and human development. Trade can also raise productivity and increase exposure to new technologies, which can also drive growth. However, none of this is automatic or inevitable[20].

[14] UNCTAD, 2005.
[15] UNDP, UNCTAD, ACP and CFC, 2007.
[16] Global Initiative on Commodities, Outcome Document, Brasilia, May 7-11, 2007.
[17] UNCTAD, 2004, pp. 230-239.
[18] UNCTAD, 2004, p. 232.
[19] UNDP Bangladesh Country Office and UNDP Nepal Country Office.
[20] UNDP, 2003, p. 21.

Much policy advice in the 1990s advanced the argument that trade liberalization "as such" is the engine of economic growth and that it is also a driving force for poverty reduction[21]. As a result, many developing countries and development partners have focused on trade liberalization. However, the trade integration policies of most LDCs has been characterized by two types of problems: (i) the projected trade expansion is delinked from the prescribed trade policies; and (ii) the prescribed trade policies are characterized by a very narrow focus. At the international level, trade policies focus on the benefits of further trade liberalization, while at the national level they concentrate on the benefits of trade capacity building. However, as indicated, trade liberalization had ambiguous effects on economic growth and poverty reduction in the LDCs.

The experience of LDCs has belied the belief that trade liberalization automatically promotes growth and alleviates poverty. According to UNCTAD[22], available evidence shows that trade liberalization has so far not been closely associated with poverty reduction[23]. Poverty appears to be increasing in the LDCs with both open and closed trade regimes. Between these extremes, poverty increased less in countries that have pursued moderate trade liberalization. While this does not imply that trade liberalization increases poverty, it does show that liberalization has not helped reduce poverty.

On the other hand, LDCs that experienced economic growth in the 1990s became more export oriented. However, increased export orientation was not necessarily associated with growth, as 'GDP per capita declined or stagnated in 8 of the 22 LDCs with increasing export orientation between 1987 and 1999; and in 10 of these countries poverty actually increased'[24]. A key lesson, therefore, is that increased exports alone do not result in poverty reduction. In this context, sustained economic growth[25] and institutional innovations, many requiring policy space, have been crucial to ensuring sustainable economic and human development for the LDCs.

Benefits for LDCs derived from further multilateral liberalization are overestimated

Sustained economic growth can be accelerated by increasing both imports and exports; however, since there is no automatic relationship between growth and poverty reduction, whether and the extent to which this happens will depend on household choices and broader government policies and spending. At present it appears that the benefits that LDCs may derive from further multilateral trade liberalization are likely to be overestimated and are actually rather small because, today, most LDCs have very open trade regimes. The LDCs will therefore derive relatively small benefits from a reduction of their own tariffs. Furthermore, LDCs benefit from many tariff-related market access preferences. They will therefore also gain relatively little from further tariff reductions by developed countries. LDCs could, however, derive relatively high gains from (i) better market access to the more industrialized developing countries, (ii) the reduction of non-tariff barriers in developed countries, and (iii) from a less restricted movement of natural persons. For instance, in 2005 official remittance inflows were approximately four times higher than net aid flows and nine times higher than FDI in Bangladesh[26]. Currently, however, multilateral trade negotiations under the Doha Round do not promise meaningful progress in these areas.

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[21] See Sachs and Warner, 1995; Dollar and Kraay, 2000.
[22] UNCTAD, 2002, Chapter 3.
[23] Among the LDCs, trade varies greatly and depends on whether their main exports are primary products, non-oil primary products, or manufactured goods. Primary products exporters exhibit the highest poverty levels. More than 80 percent of the people in mineral-exporting countries lived on less than $1 a day at the end of the 1990s, compared with 43 percent in service exporting LDCs and 25 percent in manufactured goods exporting LDCs (excluding Bangladesh) (UNCTAD, 2002, p. 115; UNDP, 2003).
[24] UNDP, 2003, p. 34.
[25] Sustained economic growth in 14 LDCs with rising GDP per capita led to a fall in poverty in them between 1987 and 1999 (UNDP, 2003, p. 34).
[26] UNDP Bangladesh Country Office.

Support needed at the international level

At the international level it is necessary to look beyond further trade liberalization and prioritize the strengthening of LDC export performance. Three types of policy measures are particularly important in this respect[27]:

- **Generally applicable support** which should focus on all developing countries and would (i) help countries cope with commodity price instability and decline; and (ii) help them address challenges associated with the management of mineral resources and mineral revenues. Specific measures under the former could include the establishment of an export diversification fund, strengthening the capacity of developing country financial institutions to provide credit to small producers and small and medium enterprises and the creation of regulatory environments enabling national stakeholders to use modern finance and risk management instruments[28].
- **LDC-specific support measures** which should focus on (i) strengthening special and differential treatment provisions, (ii) strengthening market access preferences, and (iii) the introduction of supply-side support measures. The policy instrument of market access preferences will inevitably erode, and it is therefore necessary to design new instruments to stimulate exports. But while market access preferences continue to have bite, it is essential to make the best possible use of them. To this end, market access preferences should not be undermined by the exclusion of sensitive products, the escalation of tariffs, overly complex rules of origin, or overly stringent product standards in developed countries.

  For instance, despite promising signs for export of agro based products such as tea and herbal and aromatic plants, Nepal has not been able to exploit international market access opportunities due to strict technical requirements[29]. Market access preferences should provide complete duty and quota-free access for all products for LDCs, and they should be granted on a mandatory basis by all developed countries and more industrialized developing countries. The introduction of Economic Partnership Agreements between the EU and many LDCs do not promise to improve market access preferences. An enticing feature of these arrangements is that LDCs are promised aid for the strengthening of trade capacities. Nevertheless, another feature of the arrangements is that many LDCs will need to comply with relatively stringent intellectual property rights and investment regulations, which go beyond current regulations in the multilateral trading system, and will effectively set a minimum standard for future multilateral trade negotiations.

- **South–South cooperation.** South–South trade has significantly increased and many developing countries have benefited. But the LDCs, which are marginalized in North–South trade, are also increasingly marginalized in South–South trade. While the share of LDC imports that originate in other developing countries has significantly increased, the share of imports of other developing countries that originate in the LDCs has decreased. Today, other developing countries import a smaller share from the LDCs than they did in the early 1980s. To counteract these developments it is necessary that other, more industrialized developing countries open their markets to exports from LDCs. An important instrument in this context is the Global System of Trade Preferences among Developing Countries (GSTP), of which countries should make more use.

National level priorities

Today, the focus on trade liberalization at the international level is accompanied by a focus on trade capacity building at the national level. Efforts to strengthen trade capacities typically (i) help countries implement

[27] UNCTAD, 2004, pp. 239-263.
[28] Global Initiative on Commodities, Outcome Document, Brasilia, May 7-11, 2007.
[29] UNDP Nepal Country Office.

appropriate trade policies and regulations and/ or (ii) help producers comply with product standards. There is also an increasing recognition of the need to develop transport-related infrastructure such as roads and storage facilities as part of the current priority being placed on 'Aid-for-Trade'. The development of appropriate transport infrastructure is a particularly great challenge for landlocked developing countries. For instance, difficult routes both internally and through Tanzania and Kenya further slow down and restrict Rwanda's access to markets[30] and the landlocked status of Malawi is a major handicap for its highly competitive sugar industry[31]. But while all of this is important, none of this is sufficient. The weak export performance of LDCs is not only related to trade barriers at the international level, and it is not only related to inability to ship products. The weak export performance of LDCs is more fundamentally related to their inability to compete internationally in terms of product prices and quality. In order to support efforts of LDCs to increase their world exports, it is insufficient to focus on a narrow conception of supply capacities. Instead, there is a need to broaden the focus to address productive capacities more generally. The analytical shift from trade-led development to development-led trade thus needs to be complemented by a shift from a narrow focus on supply constraints to a broader focus on productive capacities.

Current trade strategies comprise a prominent part of development strategies. While it may be an exaggeration to suggest that trade strategies have replaced development and poverty reduction strategies, trade strategies have certainly conditioned the development and poverty reduction strategies (PRSPs or otherwise) of an increasing number of countries. A more balanced relationship between trade and development will require a shift from trade-led development strategies; which bank on quasi-automatic positive effects of further liberalization of trade for growth and poverty reduction, to development-led trade strategies which instead focus on the ways in which the development of productive capacities can contribute to sustained economic growth with poverty reduction, with increased trade as a valuable instrument of development, but not an objective in itself.

From supply capacities to productive capacities

During the past decades many LDCs have not been able to effectively increase their exports. This fact shows that market access opportunities are distinct from market entry requirements. Although market access can be improved, and many market access preferences should be significantly strengthened, the LDCs already benefit from market access preferences to many developed countries, but so far only a few of them have been able to effectively use such preferences, as indicated by low levels of effective utilization. The ability of LDCs to make better use of market access preferences does not only depend on an improvement of supply capacities, in the narrow sense, but requires rather an improvement of productive capacities in the broadest sense.

In particular, the development of productive capacities will require an expansion, but also a better utilization, of the following three factors[32]:

- **Productive resources.** These refer to the factors of production, which include human, physical, financial and natural capital.
- **Entrepreneurial capabilities.** These are essentially the core competencies and technological capabilities that entrepreneurs ought to have in order to effectively use productive resources to convert raw inputs into internationally competitive outputs.
- **Production linkages**. These refer to backward and forward, and horizontal and vertical linkages between small and large enterprises, informal and formal enterprises, and domestic and foreign enterprises. They also include various linkages between the informal and formal sectors and the agricultural and non-agricultural sectors.

[30] UNDP Rwanda Country Office.
[31] UNDP Malawi Country Office.
[32] UNCTAD, 2006, pp. 59-81.

Productive capacities are closely associated with three economic processes, namely (i) the process of capital accumulation[33], (ii) the process of technological progress[34] and (iii) the process of favourable structural change, characterized by an increasing specialization in high value added activities and an increasing number of productive employment opportunities[35]. On the one side, productive capacities influence these three economic processes, but on the other hand, productive capacities are also influenced by these economic processes. However, this potentially virtuous relationship in the LDCs is constrained by three factors, namely (i) an underdeveloped infrastructure, (ii) weak institutions[36] and (iii) weak external and domestic demand[37]. It is therefore necessary to overcome these three constraints in order to develop productive capacities.

➢ Implications for investment

A key implication of the analysis above is that the LDCs need to increase investments related to the development of productive capacities (namely productive resources, entrepreneurial capabilities and production linkages). They also need to significantly step up investments which are related to productive capacities (especially in infrastructure and institutions). Only if LDCs overcome these constraints and successfully develop productive resources, will they benefit from a more favourable process of capital accumulation, technological progress and structural change. The necessary investments to develop productive capacities and to relieve constraints on them are a formidable challenge for any country, but especially the LDCs, which are resource-stripped economies. It is important to emphasize that these investments go beyond the current investment foci of many countries. Investment in entrepreneurial capabilities goes well beyond the current focus on universal primary education (it should include investment in technical and vocational training, secondary and tertiary education, research and development and extension schemes); investment in institutions goes well beyond an exclusive focus on anti-corruption measures and a favourable investment climate (with good governance and anti-corruption, it should also include the development of effective business support institutions and banks); and investment in physical infrastructure should go beyond current efforts to close the digital divide (it must include large investments in electricity grids and transport networks). According to World Bank estimates, LDCs require infrastructure investment equivalent to about 7 percent of their GDP annually[38].

External resources for development financing

The significant resource needs of the LDCs cannot be covered by their domestically available resources in the near future. This resource gap can only be financed by external resources, especially official development assistance (ODA), but also foreign direct investment (FDI). Between 1999-2003, net FDI inflows to LDCs were about 2.6 percent of GDP, while in 2004 net ODA disbursements to LDCs were about 9 percent of GDP.

These figures indicate that the LDC group has benefited from rising FDI and ODA inflows during the past few years. Nevertheless, many LDCs have been excluded because FDI is highly concentrated in a few countries (namely countries that benefit from oil, metals and minerals) and a few sectors (namely extractive industries). Moreover, ODA is also concentrated in selected countries (especially conflict-affected countries), and a few areas (namely the social sectors, emergency assistance and debt relief). In order to finance the investment necessary in LDCs it is essential that:

- **Aid is further increased.** In order for aid to play a more effective role in underpinning progress towards the MDGs, the commitments made in 2005 on increasing aid quantity must be met. In 2005, G8 summit leaders agreed to increase aid to developing countries by US$50 billion a year by 2010, with at least $25 billion a year going to Africa. A few months earlier member states of the

[33] Akyüz and Gore, 1996.
[34] Knell, 2006.
[35] UNCTAD, 2006, pp. 85-189.
[36] Kozul-Wright, 2000.
[37] UNCTAD, 2006, pp. 193-280.
[38] Briceno-Garmendia, Estache and Shafik, 2004.

European Union resolved to reach the internationally agreed target of 0.7 percent of GNI in ODA by 2015 with an interim target of reaching 0.51 percent by 2010. Donors should meet their stated commitments and do so in a manner that channels real additional resources to development. An increase of aid effectiveness will also depend on the untying of aid and further exploring opportunities for OECD countries to provide additional resources beyond those freed through debt cancellation through new innovative sources of finance (such as the International Finance Facility for Immunization (IFFIm), the solidarity Air Transport Levies (ATLs) for drugs facilities, and Advance Market Commitments for vaccine investments), some of which have the potential to deliver benefits for the LDCs. Due attention should also be directed to the growing volume of aid provided by emerging economies and measures that ensure ownership should be reinforced[39].

- **There should be a better balance between the productive and social sectors.** Much more aid needs to be committed to the development of infrastructure and the productive sectors than was the case in past years. Between 1992–1994 and 2002–2004, the share of ODA from OECD/DAC countries to LDCs committed to social sector development, emergency assistance and debt relief increased from 35 per cent to 62 per cent. By contrast, over the same period, the share of ODA from OECD/DAC countries to LDCs committed to infrastructure development and the productive sectors decreased from 48 per cent to 24 per cent.

- **Aid should be more effectively deployed.** In order to strengthen the development effectiveness of aid, it is important for donors to achieve greater policy coherence. For example, it is necessary that trade policies, which protect the agricultural sector in developed countries, do not undermine aid policies, which promote rural and agricultural development in developing countries. Furthermore, donors must achieve greater coherence in their reporting procedures, and both donors and recipient countries should use aid in a more transparent and accountable manner. With agreement in principle on the Paris Declaration, the OECD countries have already begun reforms in this area based on the principles of harmonization, alignment, ownership and mutual responsibility.[40]. The speedy and comprehensive implementation of the Paris Declaration is necessary for an increase of aid effectiveness and it can effectively promote progress towards development objectives including the MDGs. Finally, aid given for military purposes should not be included in ODA. Such an inclusion could be a fatal mistake since it will serve to undermine the development orientation of ODA.

Domestic resources for development financing

Although the LDCs have limited domestic resources and will continue to depend on high levels of aid, they can and should raise additional domestic resources to complement aid inflows. The LDCs have opportunities to raise resources for public investment through an improved tax collection system. Furthermore, they have an opportunity to make more resources available for private investment through an improved banking system.

Banks are more important than financial markets for credit provision at low levels of development. The weakness of the banking sector in LDCs is highlighted by the fact that (i) in 2003, money supply was 80 per cent of GDP in other, more industrialized developing countries, but just 31 per cent of GDP in LDCs; and that (ii) between 1980 and 2003, the share of domestic credit to the private sector doubled from 30 percent to almost 60 per cent for low- and middle-income countries, but stagnated at around 14–15 percent in the LDCs[41]. Contrary to common perceptions, the problem in LDCs is not so much that banks do not have the liquidity to make loans; it is rather that the potential borrowers do not have the collateral that banks require. In Senegal, for

[39] UNDP Senegal Country Office and UNDP Mauritania Country Office.
[40] UNDP Mauritania Country Office.
[41] UNCTAD, 2006, pp. 230-246.

example, 80 percent of loan applications by small and medium-sized enterprises were rejected because of lack of collateral[42].

Lending by microfinance institutions does not effectively compensate for the lack of activity by commercial banks, or the weakness of many national development banks. This is because microfinance institutions typically provide relatively small credit volumes at relatively high interest rates for relatively short durations, whereas real-sector investments require relatively large credit volumes at relatively low interest rates for relatively long durations. In order to ensure that the domestic private sector, especially small and medium sized enterprises, have access to loanable funds and are able to conduct necessary investment, it is essential that commercial banks as well as development banks become more effective in fulfilling their core functions.

Conclusion

Poverty reduction may be achieved through either the creation of productive employment opportunities for the poor or through different types of transfer payments in cash (e.g., payment of welfare) or in kind (e.g., provision of complimentary social services) to the poor. While these two approaches to poverty reduction might be considered contradictory, they are in fact complementary. However, the creation of productive employment opportunities is the only proven sustainable, long-term measure to reduce poverty, even though the provision of transfer payments is an important short-term measure to alleviate poverty. Despite this, and while both approaches are important, the latter approach has gained dominance in recent years. The understandable desire for quick results has encouraged developing countries and their development partners to focus more and more on "high-impact actions", which are associated with transfer payments. Today, poverty reduction efforts are mainly associated with the provision of social services; in this context, they are mainly concentrated on basic health and education. While the provision of social services is important for short-term poverty alleviation, it cannot by itself help to ensure long-term, sustainable poverty reduction. Moreover, if donors decrease their aid for social services, many poor countries will find themselves unable to provide these services to the poor. The only way for LDCs to decrease their high and sustained dependence on aid money and to sustainably invest in their social sectors in the long-run is for them to promote high and sustained rates of economic growth and employment.

While economic growth is not the ultimate objective of development, it is a necessary means. It is necessary (although not sufficient) for government revenues and essential government expenditures to increase. Furthermore, it is necessary (although not always sufficient) for the creation of productive employment opportunities and an increase in household incomes. Accordingly, this paper has argued for a production-oriented approach to poverty reduction in the LDCs. The development of enhanced productive capacities should assume centre stage in national development and poverty reduction strategies. It should also be a key concern of international development assistance.

[42] IMF, 2005.

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