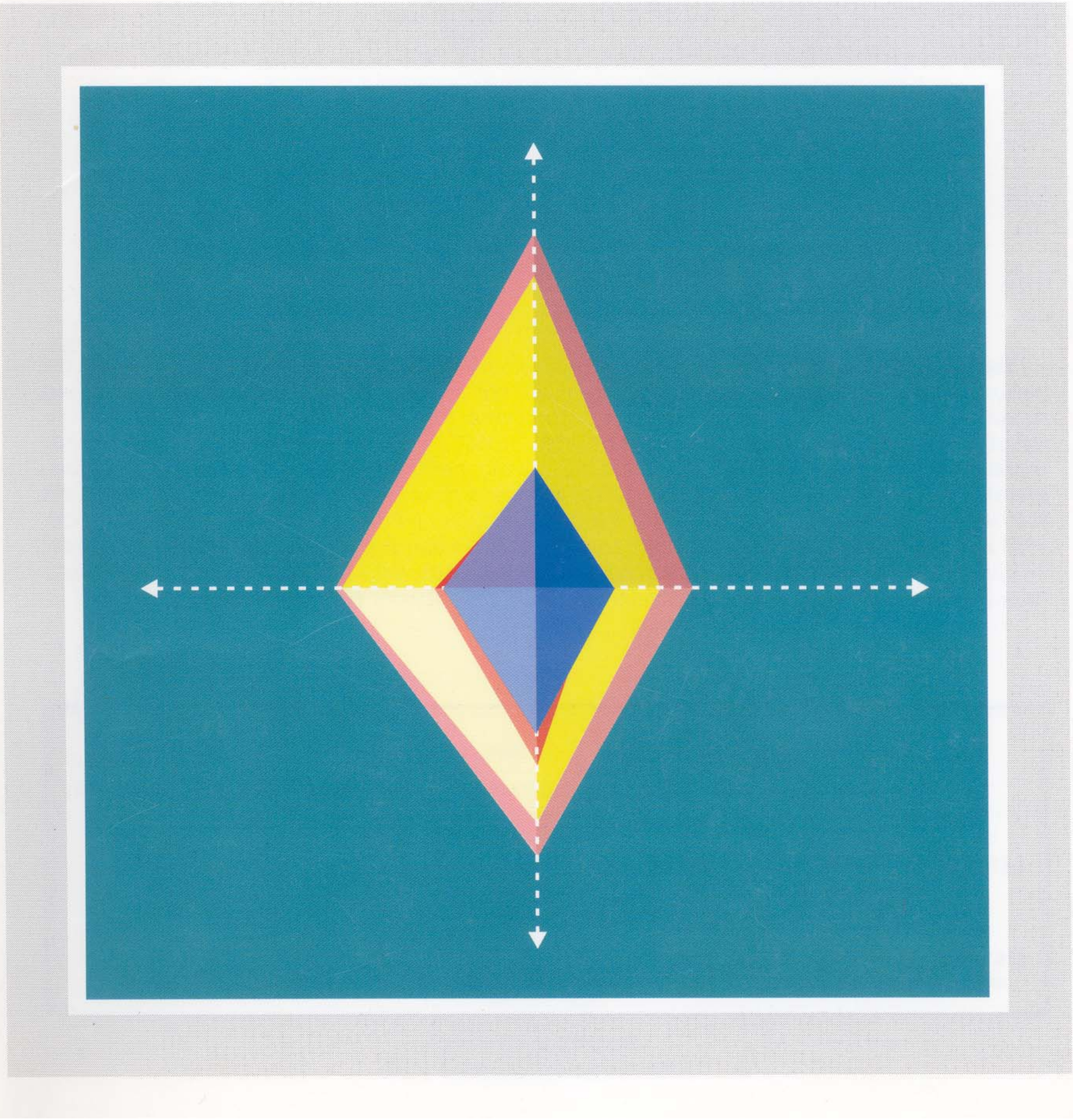
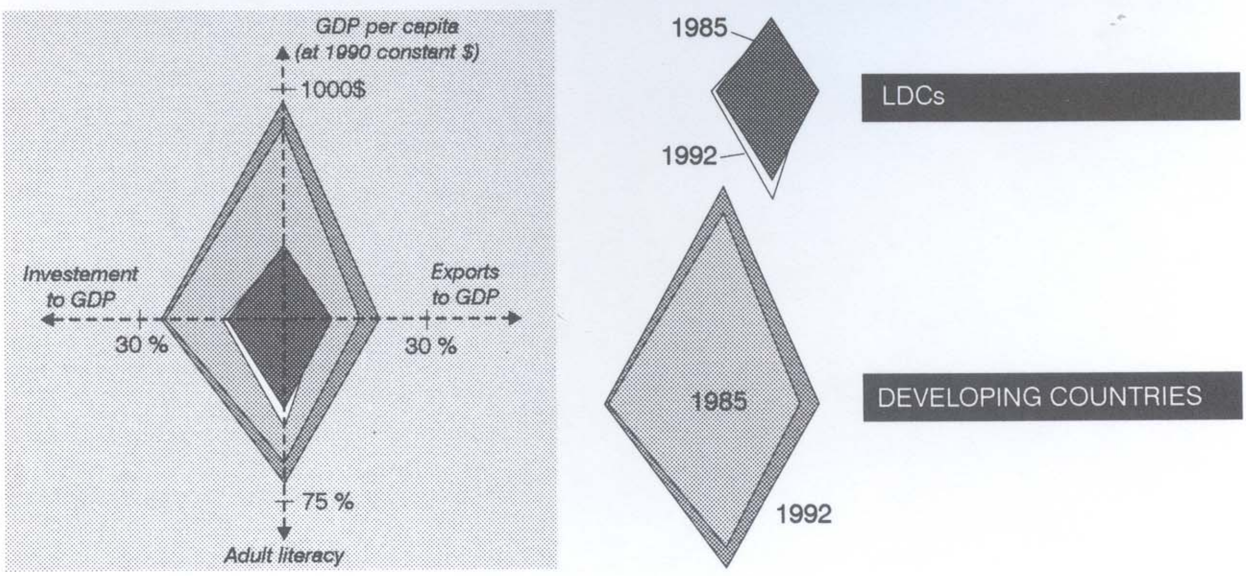
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE LEAST DEVELOPED COUNTRIES 1996 REPORT

UNITED NATIONS



MAJOR ECONOMIC INDICATORS, LDCs AND DEVELOPING COUNTRIES, 1985 AND 1992



The four diamonds in the diagram shown above (and depicted on the cover page) illustrate the performance of LDCs and developing countries with regard to key variables of social and economic development between 1985 and 1992. Each diamond represents a set of indicators for either LDCs or developing countries in either 1985 or 1992, and the points of each of the diamonds represent one of four social and economic indicators - per capita GDP in constant 1990 dollars, investment as a percentage of GDP, exports as a percentage of GDP and the adult literacy rate. All four indicators were significantly lower for the LDCs than for the developing countries in both 1985 and 1992. Moreover, between 1985 and 1992 the developing countries were able to register an improvement in all four indicators, whereas the LDCs suffered a fall in both per capita GDP and their export/GDP share, although investment and adult literacy rates improved.

Regions		*GDP per capita (at 1990 constant $)*	*Share in GDP (%)*		*Adult literacy*
			Investment	*Exports*	*as % of age 15 plus*
LDCs	*1985*	295	14	10	37
	1992	279	16	8	46
Developing countries	*1985*	804	25	17	60
	1992	917	26	20	69

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Geneva

THE LEAST DEVELOPED COUNTRIES 1996 REPORT

Prepared by the UNCTAD secretariat

UNITED NATIONS
New York and Geneva, 1996

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

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Foreword

The Least Developed Countries 1996 Report is the twelfth annual report of UNCTAD focusing the attention of the international community on the key developmental issues confronting the Least Developed Countries (LDCs), the most marginal segment of the world economy.

At the Second United Nations Conference on the Least Developed Countries -- held in Paris in 1990 -- the international community committed itself to take urgent and effective action, based on the principle of shared responsibility, to revitalize growth and development in these countries.

Actions taken so far have failed, however, to halt the social and economic decline of the Least Developed Countries. A majority of these countries are in fact experiencing deteriorating living standards, and are becoming further marginalized from the mainstream of the world economy. Reversing these trends is one of the most pressing issues confronting the world today.

Part One of this report reviews recent developments in the LDCs, their short-term outlook and prospects for growth. Part Two analyses selected issues in the context of interdependence, examining the implications for LDCs of the processes of globalization and liberalization, and presenting a set of national policies and international support measures to enhance the capacity of LDCs to benefit from globalization and liberalization. The section also deals with related issues in trade and economic cooperation between LDCs and other developing countries. Finally, in Part Three, the issue of financial-sector reform in LDCs is examined.

This year's report has an added significance in that it will serve as a background document for the Ninth Session of the United Nations Conference on Trade and Development, to be held in South Africa from 27 April to 11 May 1996. The main theme of UNCTAD IX is promoting growth and sustainable development in a globalizing world economy. The Conference will examine opportunities for enhancing development worldwide, and look at ways to prevent the further marginalization of LDCs and other weaker economies as economic globalization gains force and momentum.

At the Mid-term Global Review of the Programme of Action for the LDCs conducted during September-October last year (the outcome is contained in Annex I), I stressed the need for a stronger sense of purpose and partnership for action in support of the LDCs. Each LDC must take greater responsibility for securing its own development. There must at the same time be a much greater commitment to development by the international community as a whole.

The analyses and policy recommendations for national and international actions contained in *The Least Developed Countries 1996 Report* should contribute to an improved understanding of the longstanding issues confronting the LDCs, and of the new challenges facing them at the present juncture in the evolution of the world economy. UNCTAD IX provides a unique opportunity for the international community to address the crucial need for sustained action in support of development worldwide. The present report constitutes an important contribution to this key objective.

Boutros Boutros-Ghali
Secretary-General of the United Nations

New York, February 1996

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EXPLANATORY NOTES

The term "dollars" ($) refers to United States dollars unless otherwise stated. The term "billion" signifies 1,000 million.

Annual rates of growth and changes refer to compound rates. Exports are valued f.o.b. and imports c.i.f. unless otherwise specified.

Use of a hyphen (-) between dates representing years, e.g. 1981-1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1991/92, signifies a fiscal or crop year.

The abbreviation LDC (or LDCs) refers, throughout this report, to a country (or countries) included in the United Nations list of least developed countries.

In the tables:

Two dots (..) indicate that the data are not available, or are not separately reported.

One dot (.) indicates that the data are not applicable.

A dash (-) indicates that the amount is nil or negligible.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

Details and percentages do not necessarily add up to totals, because of rounding.

ABBREVIATIONS

ACP	African, Caribbean and Pacific (Group of States)
ADF	African Development Fund
AMS	Aggregate Measure of Support
APEC	Asia-Pacific Economic Cooperation
AsDB	Asian Development Bank
ASEAN	Association of South-East Asian Nations
ATM	automated teller machine
BCCI	Bank of Credit and Commerce International
BIAO	Banque internationale pour l'Afrique occidental
BOP	balance of payment
CFA	Communauté financière africaine
CIS	Commonwealth of Independent States
COMESA	Common Market for Eastern and Southern African States
CPI	consumer price index
DAC	Development Assistance Committee (of OECD)
DANIDA	Danish International Development Agency
DC	developing country
DFI	development finance institution
DME	developed market economy
DRF	Debt Reduction Facility
DTCI	Division on Transnational Corporations and Investment
ECOWAS	Economic Community of West African States
EDF	European Development Fund
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
FI	financial institution
f.o.b.	free on board
FSRP	financial-sector reform programme
FY	fiscal year
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFI	international finance institution
IMF	International Monetary Fund
IPRs	intellectual property rights

LPB	local private-sector bank
MERCOSUR	Southern Cone Common Market
MFA	Multi-Fibre Arrangement
MFN	most favoured nation
MNC	multinational corporation
NAFTA	North American Free Trade Agreement
NCB	nationalized commercial bank
NEM	New Economic Mechanism
NIE	newly industrializing economy
NTB	non-tariff barrier
NTM	non-tariff measure
ODA	official development assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
OFIs	other financial institutions
OMTO	open market-type operation
PPP	purchasing power parity
R and D	research and development
RAP	rights accumulation programme
RBM	Reserve Bank of Malawi
ROSCA	rotating savings and credit association
RTA	regional trading arrangement
SADC	Southern African Development Community
S and D	special and differential treatment
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDR	special drawing right
SME	small and medium-size enterprise
SOE	state-owned enterprise
SSA	sub-Saharan Africa
TB	treasury bill
TNC	transnational corporation
TRIMs	trade-related investment measures
TRIPs	trade-related aspects of intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UR	Uruguay Round
VER	voluntary export restraint
WTO	World Trade Organization

Background

The least developed countries (LDCs), which are at present 48 in number, with a population of more than 555 million,[1] are the weakest partners in the international community with the most formidable structural problems. These are often compounded by geographical handicaps and natural and man-made disasters. To assist these countries in overcoming these problems effectively, the international community unanimously adopted the Programme of Action for the Least Developed Countries for the 1990s. In the Programme of Action, the international community committed itself to undertake urgent and effective action, based on the principle of shared responsibility and strengthened partnership, to arrest and reverse the deterioration in the LDCs' socioeconomic situation and to revitalize their growth and development.

That spirit was reiterated by the High-level Intergovernmental Meeting on the Mid-term Global Review of the Implementation of the Programme of Action which was held in New York from 26 September to 6 October 1995 (see annex I). Participants in the Meeting reaffirmed their commitment to work cooperatively towards achieving the prime objective of the Programme of Action and expressed their determination to pursue their efforts to implement the measures and recommendations agreed at the Meeting. They were confident that the success of their efforts would lead to a revitalization and acceleration of growth and development in LDCs and enable them to participate in and benefit from the process of globalization and liberalization.

The Programme of Action entrusts UNCTAD with the focal role in the review and appraisal of the implementation of the Programme and its follow-up at the global level. The Declaration adopted by UNCTAD VIII, entitled "A New Partnership for Development: The Cartagena Commitment", reaffirms this mandate and provides for the Trade and Development Board to review the progress made in the implementation of the Programme of Action, during the spring segment of its annual sessions, using the Least Developed Countries Reports as background documents.

This year's Report, the twelfth in the series, will serve as a background document for UNCTAD IX and complements the Secretary-General's Report to the Conference on matters relating to LDCs.

The UNCTAD secretariat expresses its appreciation to the Governments of States members of UNCTAD and to the international organizations that have provided valuable inputs and contributions to this Report.

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1 Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, Sao Tome and Principe, Sierra Leone, Solomon Islands, Somalia, Sudan, Togo, Tuvalu, Uganda, United Republic of Tanzania, Vanuatu, Yemen, Zaire and Zambia.

Overview: LDCs in a Globalizing World Economy

Introduction

The growing interest in both official and private quarters in the phenomenon of globalization and its companion, the process of economic liberalization, has generated much thinking and analysis about its origin, its impact on economies and societies, and on the pattern of its likely evolution. Although much publicity has surrounded some of the analysis, it is clear that these multifaceted phenomena have important implications which governments, businesses and analysts all over the world must address. Much of the analysis and thinking has focused on the more visible aspects of globalization, notably, the sea-changes taking place in the pattern of production, pace of diffusion of knowledge and information and in the convergence of factor markets. Less well understood and analysed, however, is the phenomenon of marginalization.

It is far from clear how those economies and societies, including most of the LDCs that are at the periphery of global processes - and have been so over very long periods - will be affected by the recent trends. Questions such as whether globalization will assist their integration in the world economy or whether the new challenges will further weaken their already precarious links are far from academic but are at the centre of the development policy debate. There is a danger that the fragile economic and social position which characterizes many of the LDCs will deteriorate further unless major efforts are made by the LDCs, supported by the international community, to adjust to the challenges of globalization and liberalization.

The paragraphs that follow address some of these issues and attempt to outline the key role of designing appropriate policies to meet the challenges. While the discussion stresses the LDCs' perspectives, it nevertheless has relevance for other poorer economies and indeed for wider global community.

Globalization and Liberalization

The world economy is increasingly being shaped by the processes of globalization and liberalization. These are interrelated and multifaceted processes encompassing the growth of international trade in goods and services and capital flows, the global integration of production processes, the dominance of market-oriented economic policies throughout the world, and a significant degree of institutional harmonization between countries in respect of trade, investment and other policies mediated through multilateral and regional institutions. Globalization and liberalization are processes that are unlikely to be reversed in the foreseeable future and have profound implications for LDCs in terms of their position in the world economy, their development prospects and the nature of their economic policies.

Integration of Developing Countries into the World Economy

Many countries in the developing world have made substantial progress in economic development over the course of the last two to three decades. Progress has been most marked in East Asia, but has not been confined to this region. The successful developing countries (DCs) have achieved rapid rates of economic growth, established internationally competitive industries, gained a growing share of world export markets, attained high rates of investment in physical and human capital, and have begun to close the disparities in income between themselves and the industrialized countries. Integration into the global economy has facilitated the development efforts of these countries, particularly through the opportunities it has provided them to accelerate the growth of their exports and to access foreign capital and technology. Globalization, however, may have converse effects for some of the weaker DCs, and, in particular, could lead to their marginalization.

Marginalization of the LDCs

While many DCs have assumed an increasingly prominent role in the global economy, many of the LDCs are becoming marginalized from the mainstream of the world economy. Marginalization is the consequence of the combination of developments in the global economy that have not been favourable to weaker economies, such as the LDCs, or to their internal political and economic problems. These two sets of factors have interacted to reinforce their marginalization.

As a group, the LDCs have not fared well in terms of economic development over the last two decades, although some individual countries have made significant progress. Economic growth has been very slow and has failed to keep pace with rapid population growth, as a consequence of which per capita incomes and living standards have declined and poverty has intensified.

The marginalization of a significant number of the LDCs from the mainstream of the world economy is reflected in an array of important economic and social indicators. Not only have LDC growth rates lagged behind those in other DCs since the early 1970s, but the LDCs' share of world exports and imports has fallen sharply. The LDCs have attracted a negligible share of global flows of foreign investment, and their investment rates, as a percentage of GDP, have been much lower than the average for all DCs. They have achieved very little structural change and remain heavily dependent upon primary commodities for export earnings and on official development assistance (ODA) to finance a large share of their investment and government budgets.

Growing Income Inequalities

A related manifestation of the marginalization of the LDCs is the increasing income disparities between them and both the industrialized countries and other DCs. The differential in per capita incomes between the countries with the poorest 20 per cent of the world population (a group that consists mainly of the LDCs) and the richest 20 per cent widened considerably between 1960 and 1991, as did the disparity between the poorest countries and those in the middle range of the income distribution (see the box below). Conversely, income disparities between the industrialized countries and the middle range of the income distribution have narrowed, reflecting the economic advances made by many of the DCs.

Reasons Underlying the Poor Economic Performance of the LDCs

The poor economic performance of the LDCs, both in absolute terms and relative to that of other DCs, reflects the impact of a number of factors. About one third of the countries in the LDC group have been afflicted by acute civil strife and political instability which have severely retarded development efforts and, in some cases, have had devastating economic and social consequences. Restoring peace and security is imperative if development is to begin again in these countries. In other LDCs, a range of problems relating to structural constraints, adverse external shocks, such as depressed commodity prices and the debt crisis, and policy weaknesses have impeded development efforts. Most of these countries have implemented policy-reform programmes in recent years designed to liberalize their economies and to enhance their integration into the international economy. Policy reforms have made some impact in terms of economic stabilization, but in most LDCs have yet to stimulate the significant acceleration of growth rates that is required to revive their economies.

This report argues that the processes of globalization and liberalization offer LDCs important long-term opportunities to reverse the economic decline that they have experienced over the last two decades, but that these processes also raise serious concerns for these countries. In the absence of appropriate policy responses from the LDCs and the international community, globalization and liberalization may do little to alleviate the trend towards their marginalization from the world economy and may even accentuate it.

Opportunities for LDCs in the Global Economy

The opportunities provided by globalization and liberalization arise mainly from changes in the global economy which are likely to enhance market opportunities for LDCs' exports, and may stimulate increased foreign investment. Growth in world trade is expected to be robust over the next decade as a result of the Uruguay Round trade liberalization and the growth of new markets in the transitional and developing economies, which should stimulate demand for LDCs' exports. It is also likely that new markets will emerge for LDCs to develop niche exports in areas such as horticulture and tourism, and that as wages rise in the newly industrialized economies (NIEs), labour-intensive manufacturing exporters may relocate to LDCs to take advantage of lower labour costs, which would provide a stimulus for export diversification in the LDCs. Integration into world markets offers major advantages for LDCs, not least because their own domestic markets are too small to provide viable investment opportunities for many potential investors. However, LDCs may not be able to exploit the opportunities offered by globalization because of pervasive supply-side constraints.

Supply-side Constraints

The ability of LDCs to take advantage of the emerging opportunities in world markets depends crucially on their ability to foster the development of internationally competitive industries which can meet exacting standards of cost, quality, reliability and delivery schedules. Supply capacities in LDCs are, however, very weak for a variety of reasons and this is likely to be the major constraint on their ability to exploit the opportunities arising from globalization. In particular, the private-enterprise sector, which is the key agent of development, is not well developed in most LDCs and its growth is constrained by shortages of capital and of entrepreneurial, managerial, technical and marketing skills. Technological capacities in many industries in LDCs are rudimentary, which, together with the low levels of educational attainment of the workforce, is a major impediment to raising productivity. Some of the services necessary to support production, such as the provision of adequate finance or marketing services, are often lacking or are very expensive. There are serious deficiencies in the physical infrastructure with the land-locked countries, in particular, facing very high transport costs to access international markets. Supply-side constraints have always been an impediment to development in the LDCs, but their importance has been heightened by globalization and liberalization because of the increasing premium on the efficient production of traded goods.

Risks for LDCs from Intensified Competition

Globalization and liberalization present a number of potential dangers for LDCs which, unless they can overcome the supply-side constraints discussed above and improve the productivity of their industries, threaten to accentuate their marginalization in the world economy, which is becoming more competitive as protected markets are increasingly opened up by liberalization and as competition among exporters is boosted by new entrants emerging from previously closed transitional and developing economies. Consequently, LDCs will face intensified competition in their major export markets in the industrialized countries and in their own domestic markets. This competition is potentially problematic for LDCs because many of their industries, especially those that were established to serve protected markets, are likely to be less efficient than their competitors and may lack the resources required to improve efficiency to the levels necessary to compete. LDCs may therefore suffer a further erosion of their share of world export markets and a possible loss of domestic market share to increased import competition.

Costs and Benefits of the Uruguay Round for LDCs

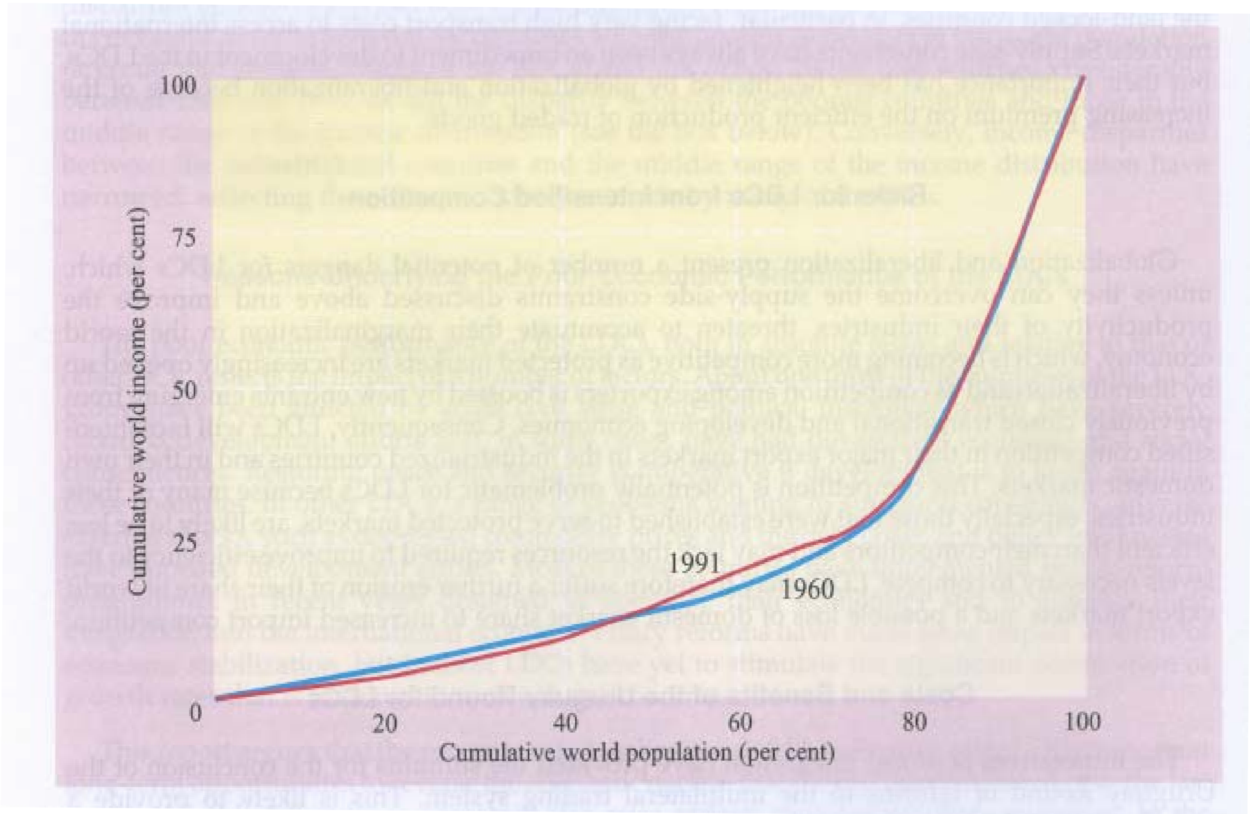
The imperatives of global integration have provided the stimulus for the conclusion of the Uruguay Round of reforms to the multilateral trading system. This is likely to provide a significant stimulus to world trade and therefore potentially enhance trading opportunities for LDCs. Although reaching definitive conclusions as to the costs and benefits of the Uruguay Round Agreements for particular countries is difficult at this stage, the major gains are likely to

Box: Convergence or Divergence in the World Economy and the Marginalization of the LDCs

There is currently much concern that globalization and liberalization are accentuating income disparities in the world economy, with most of the benefits accruing to the already industrialized economies and a relatively small number of newly industrialized economies (NIEs), while the weaker DCs become poorer and progressively marginalized. But whether such a "divergence" in the world economy is an inevitable consequence of globalization and liberalization is subject to much dispute. There are conflicting theoretical arguments to support both the "divergent" view of the world economy, and the opposite "convergent" view that global integration will in fact enable poorer countries to close the income gap with the richer countries. The convergent view draws support from traditional trade theories and arguments relating to the declining marginal efficiency of capital. Proponents of the divergent view doubt the validity of these arguments and instead stress the effects of structural characteristics in the world economy and the tendency of capital and skilled labour to gravitate towards the more dynamic regions of the world (see box 5 in Part Two).

The empirical evidence of trends in income distribution over the last three decades reveals that both convergence and divergence have taken place simultaneously, as illustrated by the Lorenz curve below and the data in the table. A significant number of DCs, including some of the larger Asian countries, have achieved rapid economic growth and have begun to narrow the gap between themselves and the industrialized countries. This is reflected in the growing share of world income accruing to the middle quintile of the income distribution (see table below). Conversely, the poorest quintile of the world-income distribution has suffered a marked decline in its share of world income - from 4.9 per cent to 3.6 per cent - during the last three decades. This quintile of the income distribution in the 1990s was comprised largely of LDCs and includes the majority of the LDCs (it excludes the island LDCs). The downward trend in their share of world income provides a clear indication that these countries are becoming further marginalized in the world economy. While most of the rest of the world has made progress in expanding their economies and raising living standards, the majority of the LDCs have experienced a stagnation in output and declining living standards.

Chart: Lorenz curves of world-income distribution, 1960 and 1991



Box (concluded)

Table: Distribution of world income by quintiles

Quintile	*1960 Real GDP per capita[a] (PPP$)*	*1960 % of world income*	*1991 Real GDP per capita[a] (PPP$)*	*1991 % of world income*
First	7,132	64.4	17,366	63.7
Second	1,961	17.7	4,294	15.7
Third	767	6.9	2,933	10.8
Fourth	678	6.1	1,692	6.2
Fifth	537	4.9	973	3.6
Mean income	2,215		5,452	
Ratio of richest to poorest quintile	13.3		17.7	
Gini coefficient[b]	0.523		0.519	

Source: UNCTAD secretariat, based on UNDP data provided by the Human Development Report office, UNDP.

[a] Purchasing power parity per capita real GDP.

[b] The Gini coefficient takes a value between 0 and 1: higher values denote greater inequality.

accrue to the industrialized countries and NIEs that have already established internationally competitive industries and which are thus in a position to compete in liberalized markets, rather than to the LDCs.

The Uruguay Round may also impose costs on LDC economies through a number of channels. As a result of Uruguay Round MFN tariff cuts, the LDCs will suffer an erosion of tariff preferences in their export markets: these are provided under GSP schemes and (for those LDCs which are members of the ACP group) the Lomé Convention. However, preferences *per se* have not been very effective in boosting LDC exports in the past and their reduction therefore may have limited practical impact. Agricultural liberalization in the industrialized countries is likely to induce a rise in world food prices. As many LDCs are net food importers, this will have an adverse effect on their terms of trade as well as on domestic food security. There may also be costs for the LDCs arising from compliance with notification requirements, policing various agreements and in participating in WTO activities. Some of the LDCs' potential concerns were acknowledged in the Final Act of the Uruguay Round which provided them with special and differential treatment allowing them greater flexibility and a longer time-frame to comply with multilateral commitments.

Constraints on Access to Foreign Capital

More than any other group of DCs, the LDCs are heavily dependent upon external finance to fund trade deficits, supplement government budgets and finance investment. The major sources of external finance for the LDCs are concessional funding from official sources and foreign direct investment (FDI). But their marginalization risks undermining their access to both sources of external finance.

Because their domestic private sectors are so weak, LDCs require the capital, technology and skills that FDI can provide if they are to improve supply capacities in their industries. Foreign investment in the developing countries has risen markedly in the last few years, but very little of it has been directed towards the LDCs. Their share of the total FDI flows to all DCs amounted to only 1.1 per cent in 1992-1994. FDI has been concentrated in the richer and more dynamic DCs, especially those in East Asia and Latin America. Furthermore, some foreign companies have been disinvesting from some LDCs in Africa in order to refocus their operations on other regions of the world where economic prospects are regarded as more promising.

As part of wider programmes of economic reform, many LDCs have reformed their investment policies in an attempt to attract FDI. But foreign investment in these countries is deterred by a variety of factors not readily amenable to policy reforms: the small size of the domestic market, inadequate infrastructure, falling world prices for primary commodities, and, in some cases, political instability.

With limited access to private capital, the role of ODA in meeting LDCs' external financing needs has assumed even greater importance. ODA flows to LDCs have, however, stagnated in the last few years. Some of the donors have re-prioritized their aid commitments, for political or commercial reasons, away from the LDCs. With the end of the cold war, most of the LDCs no longer have much strategic significance for the major donors and are perceived as providing few commercial opportunities for firms from the donor countries, while political instability has severely reduced the absorptive capacity for external finance in some LDCs. Hence, LDCs are facing severe constraints on their access to concessional finance at a time when enhanced flows of external resources are most needed.

Trends in World Commodity Markets

Most LDCs remain dependent upon exports of primary commodities to generate their foreign-exchange earnings. Trends in world commodity markets since the 1970s, however, have not been favourable to LDCs. There has been a long-run decline in the real prices of many of the commodities which are of particular importance to LDCs, such as coffee, copper, cotton and tea. This reflects the fact that the growth in world market demand for primary commodities has lagged behind that of other products, partly because of a fall in the commodity intensity of final expenditures, while supply has been boosted by productivity increases linked to the application of new technology in some important supplier countries. It is possible, but by no means certain, that the demand for some primary commodities, especially metals, minerals and agricultural raw materials, may pick up over the medium term because of the rapid economic growth in Asian countries where the demand for raw materials is outstripping supply.

The LDCs have also lost market share in the world markets for many of their major primary commodity exports, including coffee, copper, metals and minerals because of domestic production constraints and productivity improvements in competitor countries. Reversing this trend in their market share is imperative if the LDCs are to participate more fully in the global economy.

Regional Trading Arrangements

Despite the multilateral agreements reached under the Uruguay Round, the growth of regional trading arrangements (RTAs) has accelerated, with new RTAs being established, the membership of existing RTAs expanded, and formal links established between different RTAs. Most LDCs are themselves members, together with other DCs, of RTAs in their own regions. But they are not included in the major RTAs, such as the EU and NAFTA, which encompass their major export markets. This has potentially important implications for the LDCs.

The creation of an RTA entails the granting of preferential market access to its own members, and hence discrimination against non-members. LDCs therefore stand to suffer a relative erosion of the terms of market access in their major export markets as a result of the growth of RTAs covering these markets, with the danger that their exports will lose market shares to exports originating from within the RTA. From the perspective of the LDCs wishing to expand and diversify their exports, it is imperative that RTAs maintain a liberal trading stance towards the rest of the world (i.e. do not raise protectionist barriers to non-members). LDCs will be in an especially vulnerable position if competing trade blocs turn inward looking, with each adopting protectionist policies towards non-members.

The African LDCs, in particular, are involved in a number of RTAs in their own regions (ECOWAS, COMESA and SADC are among the largest of these groupings), but these RTAs have not yet proved effective in stimulating intraregional trade flows. There is limited complementarity in the economic structures of the different country members, intraregional transport links are often poor, while the degree to which trade barriers between members have actually been removed has been limited, partly because governments have lacked the political will to vigorously pursue regional trade integration which might threaten the interests of domestic producers. Nevertheless, such RTAs would offer potential advantages to LDCs if intraregional trade were effectively liberalized, especially because their own domestic markets are so small. Domestic firms would enjoy the benefits of the larger regional markets, allowing them to exploit economies of scale, while the increased competition would stimulate improvements in efficiency. Regional markets may provide a useful training ground for domestic firms seeking to raise productivity to international standards before entering global export markets. The larger regional market might also prove more attractive to investors than individual country markets.

Implications of Globalization and Liberalization for Economic Policy in LDCs

Responding to the challenges posed by globalization and liberalization will require major adjustments in economic policies, resource allocation and production structures in the LDCs. The primary burden of adjustment will inevitably have to be borne by the LDCs themselves, although international support is essential. The nature and quality of domestic policies will play a crucial role in determining whether LDCs can successfully adjust to the changing demands of the global economy.

Globalization and liberalization have important implications for the nature of economic policies in LDCs. The scope for autonomous national economic policies has undoubtedly been narrowed as a result of these trends in the world economy. Direct controls by governments over economic activities within their own national boundaries (e.g. controls on capital movements) have become less effective and often counter-productive, as private-sector economic agents are more easily able to evade the impact of such controls. As a consequence, governments have few options other than to pursue market-oriented economic policies.

The focus of economic policies has therefore shifted towards the creation of an enabling environment for the private sector and the efficient operation of the market economy. This entails maintaining macroeconomic stability, developing an appropriate legal and regulatory framework (to enforce contracts and protect property rights), and ensuring the efficient provision of public goods, such as education and health services, which cannot be supplied in an optimal manner by the market.

At the same time, globalization has significantly enhanced the premium on good macroeconomic policies and exacerbated the adverse repercussions of bad policies. Because of the increasingly competitive nature of global trade and factor markets, the latitude that governments may once have had to follow inappropriate policies, such as overvalued exchange rates, without inflicting serious damage on their economies, has been diminished.

Maintaining macroeconomic stability, adopting outward-oriented trade policies and avoiding excessive distortions in markets will be crucial policy requirements for all LDCs. In addition, public policy must address the critical supply-side constraints that impede the ability of their economies to compete effectively on global markets. Although the requirements of individual LDCs will not be identical, several areas are likely to warrant the attention of policy makers. These include strengthening the export sectors, improving agricultural technology in order to enhance farm productivity and output and rehabilitating and expanding the physical infrastructure. Major efforts are also required to enhance human-resource development, particularly by raising the level of educational attainments, which is crucial to raising the productivity and competitiveness of the economy.

The adjustment efforts of LDCs require more support from the international community. A crucial role for the international community will be to provide adequate levels of concessional finance to fund the infrastructural and social development programmes of LDC governments and to provide the balance of payments and budgetary support to facilitate economic-reform programmes. Technical assistance to enhance capacities for policy formulation and implementation in LDCs is also required. The international community must ensure that the market access of LDC exports is not undermined by protectionism, and that the growth of RTAs covering the major industrial countries does not damage the trading interests of LDCs.

LDCs' Recent Growth Performance

After many years in which the per capita incomes of some LDCs stagnated and others declined, LDC economies displayed some modest progress in 1994 and 1995. GDP growth was estimated to have averaged over 3 per cent in these two years. Of the 48 LDCs, 14 were estimated to have experienced strong economic expansion in 1995, with output growth of more than 5 per cent. Barring adverse weather conditions, LDC output growth in 1996 should be sustained and reach the same level as in 1995, notwithstanding the expected weakening of certain commodity prices.

The overall improvement in LDC economic performance was due to a combination of factors including the progress made in enhancing political and social stability in some countries, the benefits accruing from the impact of domestic economic-policy reforms, favourable weather conditions, and increased commodity prices from about 1994 which are likely to be reversed within the next year or two. The efforts to implement more prudent fiscal and monetary management, so as to reduce macroeconomic imbalances, contributed to lower inflation in several countries and the return of investor confidence. Increased export-tax revenues due to higher export earnings, together with the curtailment in the growth of public expenditures, have contributed to an improvement in public finances in a number of LDCs.

African LDCs

The most notable improvement in economic performance has occurred in the African LDCs, although their growth rates remained modest in comparison with Asian LDCs. Aggregate GDP growth of the African LDCs was estimated to have increased to 2.2 per cent in 1995, compared with an annual average growth rate of 0.6 per cent in 1990-1994. Eight of these countries experienced output growth of more than 5 per cent in 1995: their economies benefited from the favourable international and domestic environment, with buoyant commodity prices boosting export earnings.

The 1994 CFA franc devaluation also helped to stimulate economic activities and encouraged increased inflows of foreign capital to some CFA member states. While favourable weather boosted agricultural output in many LDCs, drought conditions afflicted some of the poorest countries of Southern Africa. There was significant progress in implementing macroeconomic reforms in many LDCs. Some countries, however, continued to experience difficulties in reducing their excessive budget deficits: this resulted in high interest rates and deterred the private investments necessary for sustained GDP growth. Although signs of peace and relative stability started to emerge in some African LDCs in 1995, civil strife continued to afflict others and impeded the revival of their economies.

Assuming normal climatic conditions, the overall GDP growth of African LDCs should be maintained in 1996 at about the same rate as in 1995. Moreover, there is potential for some countries to accelerate their output growth rates through the expansion of their agricultural and mineral sectors.

Asian LDCs

Economic growth of Asian LDCs increased to 4.6 per cent in 1995, from 4.0 per cent in 1994. Two thirds of the Asian LDCs succeeded in expanding output by more than 5 per cent, with three of these countries achieving growth rates close to 7 per cent. The impetus for growth was provided by the revival of business confidence induced by a deepening of reform measures, which included the maintenance of realistic exchange rates and low inflation rates, together with enhanced cooperation in trade and investment with neighbouring countries, particularly in South-East Asia. The economies of many of the Asian LDCs have also benefited from the social stability that prevails in these countries. Favourable weather conditions contributed to a good agricultural performance in a majority of the countries in the region, while industrial growth remained robust and several countries recorded an encouraging export performance. Some of the Asian LDCs have begun to attract FDI, often in the form of joint ventures with local investors, in various sectors from agriculture to infrastructural improvements. However, these countries still face enormous problems, with large sections of the population unemployed and living below the poverty line.

External Finance

Overall Aid Flows are no longer Increasing

For several decades, the increase in aggregate DAC ODA to developing countries as a whole broadly corresponded with increases in donor countries' GNP, but the period of steady growth in ODA appears to be over. Shortages of ODA are likely to continue into the future with LDCs competing with other developing countries and new aid claimants for scarce aid resources. International commitments made in the Programme of Action in 1990, and subsequently endorsed at recent major global conferences, appear to have had little impact on donor policies (see chart).

The key features of diminution in the importance of external resource flows to the LDCs in the first half of this decade include:

- stagnation of ODA;
- reductions in the GNP share of donor countries allocated to foreign-aid programmes;
- limited contribution of private capital to net-resource flows to LDCs;
- decline in support from some multilateral institutions over the last two years;
- the continuing drain on resources deriving from debt-servicing obligations.

In nominal terms, ODA flows have stayed relatively stable over the first half of the 1990s, although in real terms they have contracted since 1991. The share of LDCs' ODA in DAC donors' GNP declined from 0.09 per cent in 1990 to 0.07 per cent in 1994 - less than half of the aid targets and commitments set at the Paris Conference, and with fewer donor countries meeting those targets than in 1990.

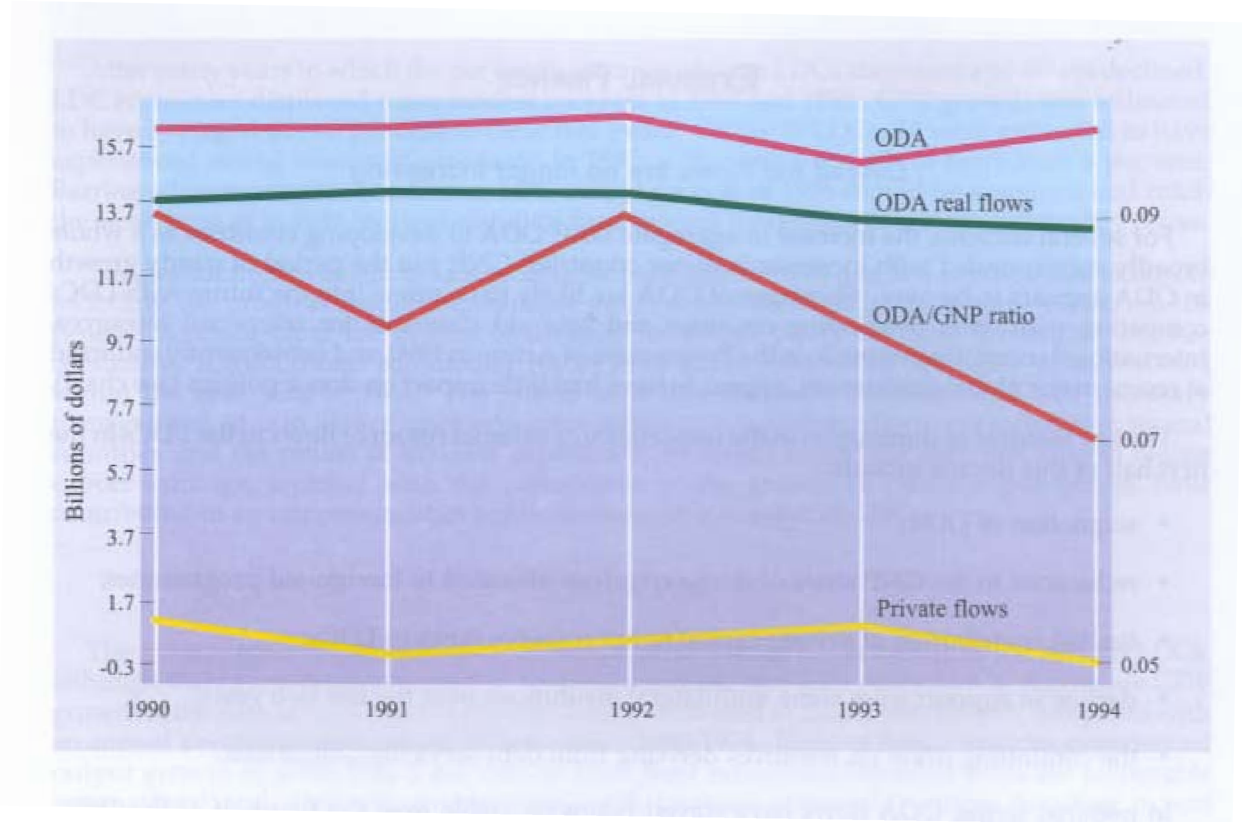
Some donor countries have made laudable efforts to maintain, and even increase, their aid budgets to LDCs. Five countries - Denmark, the Netherlands, Norway, Portugal and Sweden in 1994 continued to meet and exceed the 0.20 per cent target. However, due to modest growth and widespread unemployment, a number of donor countries have cut back their aid budgets and reduced allocations to LDCs. In the United States, reducing the budget deficit and cutting expenditure have become overriding policy concerns: likewise, some members countries of the European Union striving to meet the Maastricht criteria for participation in the single currency of the European Monetary Union by 1999 have also adopted further fiscal restraints. In these circumstances, aid budgets have become an easy target, with no clearly defined constituency to defend them. Japan, currently the second largest donor to the LDCs in dollar terms, has also been undergoing a prolonged period of economic weakness and is also likely to result in a slow-down in its aid programme.

LDCs Struggle to Meet Policy Conditions

Policy conditions have come to the centre of donor-recipient relations, notably for access to Structural Adjustment Loans and Structural Adjustment Facilities of the World Bank and IMF, respectively. Of late, political conditionality relating to "good governance", including the guarantee of human rights has also assumed increased importance.

Many LDCs have weak administrative and institutional capacities that hamper the local design and "ownership" of reform and development programmes, as well as their implementation. In most cases, these limit LDCs' real absorptive capacity and impede the effectiveness of aid.

Chart: ODA and private flows to LDCs, 1990-1994



Besides economic-policy reform, a significant number of LDCs have, since the early 1990s, undertaken wide-ranging political reforms and have instituted mechanisms for democratization and increased popular participation in the development process. Carrying out these two major reforms in tandem has overstretched the weak administrative capacities of most LDCs and held up progress on economic reform measures, thereby slowing down aid inflows. In other LDCs, political conflicts and civil strife have led to the suspension of regular development programmes and projects.

Decline in Aid to LDCs is not Inevitable if Priorities are Set Right

The fiscal constraints in donor countries need not necessarily lead to a reduction of ODA flows to the neediest countries, such as the LDCs, if aid programmes are refocused and prioritized. With even modest increases in the funding of multilateral aid programmes and priority allocations to LDCs within bilateral aid, it should still be possible to meet the aid targets and commitments set out in the Programme of Action and ensure adequate ODA financing for the LDCs. The mid-term review of the implementation of the Programme of Action in late 1995 suggested specific measures to incorporate these targets and commitments into the donors' national aid strategies and budgetary planning mechanisms. In parallel, possible new sources of ODA financing need to be explored: the mid-term review meeting invited developing countries, which have developed the capacity to assist over the last few years, to join the traditional donor countries in providing assistance to LDCs. Contributions by non-governmental organizations should also be encouraged.

To counteract the possible marginalization of LDCs in ODA financing, the donor community, together with its LDC partners, will have to address procedural as well as performance-related absorptive capacity constraints. The former may stem from complex aid procedures and practices, which are different for each bilateral donor and agency, procurement restrictions, regulations within the recipient countries themselves, and insufficient coordination of aid programmes, among others. The second set of policy-related constraints, connected with the current stringent aid conditionality which many LDCs find difficult to fulfil, calls for increased efforts at capacity-building and realism in setting performance criteria: e.g. adapting these to the management and implementation capacities of the recipient countries, seeking to smooth the path of adjustment rather than block support when countries run into difficulties.

LDCs' External Financing Situation Remains Precarious

Although issues like the effectiveness and targeting of aid are important, the question of the volume of aid remains a crucial concern. The current flow of aid is in part based on past commitments, as disbursements are made for programmes and projects agreed earlier. However, commitments have fallen back in recent years. The precarious position of LDCs' external financing is indicated by the fact that, during the first half of the decade, net transfer of resources has been possible in part due to factors such as default on a part of LDCs' debt service obligations, through debt relief and through the accumulation of arrears.

The Outcome of ongoing Multilateral Replenishment Exercises will be Crucial

In order to maintain and expand aid flows to the LDCs, absorptive capacity constraints have to be addressed, as suggested above. But funding capacity and a sufficient pipeline of commitments also have to be secured. In this respect, 1996 will be a critical year. Much will depend on developments in the major donor countries, and the outcome of ongoing negotiations on the replenishment of the concessional windows of the international financial institutions, which are key sources of financing for the LDCs.

In the United States, the leading donor country so far for the LDCs in terms of aid volume, public and political support for the aid budget remains doubtful. Major cutbacks in the United States aid budget would have serious consequences for LDCs, and possibly have repercussions on support from other donor countries as well. At the end of 1995, the capacity of the International Development Association (IDA) to undertake its planned 1996 operations was in doubt, largely because of the uncertainty about the United States Congress authorizing the funds to meet the current commitments to IDA. Similar pressures influenced the negotiations on the next IDA replenishment, due to take effect at the beginning of July 1996, and discussions on the provision of new resources to the African Development Fund and the Asian Development Fund, both of which are in line for replenishment.

Bolder Action on LDCs' External Debt is Needed

ODA financing has to be complemented by concerted efforts on the debt strategy for the poorest countries, with a view to reducing their external obligations to sustainable levels. A number of mechanisms have been set up to deal with the specific debt problems of low-income countries, including schemes for ODA debt relief and other official debts to Paris Club creditors and for buying back liabilities to commercial banks. Given its size, and the increasing burden of servicing it, the multilateral component of LDC debt has assumed critical importance. Then again, their preferred creditor status appears to lessen the options to deal with it. Discussions on policies to deal with this component of the debt of poorer countries have been going on for some time now in the Bretton Woods institutions, but progress has been limited. The ad hoc solutions adopted so far have had little impact on the LDCs' debt overhang. A significant number of LDCs, in particular those that experienced stagnant growth and/or decline in their export earnings in the early 1990s, are still unable to meet their debt-servicing obligations.

Bolder action is needed on this front, in addition to the provision of new ODA financing. This should include, in many cases, a substantial reduction of the outstanding debt stock. A comprehensive and concerted approach is needed: a sufficiently endowed facility to deal with multilateral debt, together with extended implementation of existing schemes, could play a key role in achieving overall debt sustainability. Nevertheless, other mechanisms may still be needed to deal with other specific LDC debt problems, such as liabilities stemming from debt contracted with the former socialist states and the debt burden of conflict-stricken countries in some of which systems of governance have broken down. Moreover, for some of the LDCs with heavy debt burdens, eligibility criteria under existing schemes is blocking debt relief. The debt problems of LDCs are still very far from a durable solution.

Financial-Sector Reforms in LDCs

Major economic-policy reforms have been implemented in most of the LDCs to facilitate their adjustment to the challenges posed by liberalization and globalization. An important component of the policy-reform programmes in many LDCs has been financial-sector reforms. The financial sectors of LDCs display a variety of weaknesses which are a serious impediment to the growth of a dynamic market economy. These weaknesses include low levels of financial depth, a lack of diversification in financial markets, the exclusion of important sections of the economy from access to credit and other financial services, banking markets characterized by inefficiency and oligopoly, and widespread financial fragility among banks and other financial institutions. These problems are attributable partly to the effects of previous financial-sector policies which sought to control financial markets in order to meet non-commercial objectives: financial fragility, for example, has been most acute among government-owned banks whose lending has been heavily influenced by political criteria.

Financial-sector reforms in the LDCs have encompassed a number of objectives: enhancing the efficiency of financial intermediation, boosting deposit mobilization, stimulating greater competition in financial markets and addressing the problems of financial fragility. The overall aim of the reforms is to promote the development of a competitive, efficient and prudently-managed financial sector capable of providing the financial services required to support the growth of a dynamic private enterprise sector. The main components of the reforms have been financial liberalization, the restructuring of distressed financial institutions, and the strengthening of systems of prudential regulation and supervision. Most of the reforms have been initiated relatively recently and in many countries are still in the process of implementation.

Financial Liberalization

Financial liberalization in LDCs has mainly comprised the reduction or removal of allocative controls over interest rates and lending, the introduction of market-based techniques of monetary control and the easing of entry restrictions on private capital. There are some indications that financial liberalization has stimulated greater competition, at least in some segments of financial markets, with the entry of new banks and other financial institutions. One of the benefits of this is that banks are beginning to improve and expand the range of services they offer to the public, particularly through investment in new technology. In addition, liberalization has encouraged the government financial institutions to place more emphasis on the application of commercial principles in determining lending decisions and in their overall operations.

The impact of financial liberalization on the efficiency of resource allocation has, however, been limited, largely because of problems relating to macroeconomic instability and financial fragility. Large government budget deficits in several LDCs have forced nominal interest rates to very high levels and crowded the private sector out of credit markets. Some of the government banks, which dominate financial markets in some LDCs, require major financial and managerial restructuring to enable them to perform as efficient commercially oriented financial intermediaries. Furthermore, there are serious imperfections in some sections of the credit markets in LDCs which impede access to credit by potentially important borrowers, such as small farmers, from commercially oriented financial institutions. These imperfections centre around informational problems, lack of suitable loan security, deficiencies in legal systems that impede loan recovery and high transactions costs. Effective institutional solutions to these problems have not yet been devised in most LDCs.

Bank Restructuring

Bank-restructuring programmes are currently under way in several LDCs to tackle the problems of insolvent (mainly government-owned) banks. The restructuring of these banks entails recapitalization, usually with funds provided by the government budget, the replacement of their non-performing assets with other assets (usually government bonds), radical changes to their management and operating procedures and the rationalization of staffing levels and branch networks to reduce operating costs. The difficulties involved in these restructuring exercises are substantial: not only are the financial costs (which will ultimately be borne by taxpayers) enormous, but there are likely to be political constraints to the type of major rationalization needed to restore viability to these banks.

Reforms to Prudential Regulation and Supervision

Reforms to the prudential systems in LDCs have entailed revisions to the banking laws and the strengthening of bank supervision departments. Prudential regulation had not been accorded much priority until the late 1980s, with the banking laws having become outdated in most LDCs and bank supervision departments severely understaffed. As a result of the reforms, the legal framework for prudential regulation has been significantly improved in many LDCs, with banking laws brought into line with international standards. While some progress towards strengthening supervisory capacities has been attained, personnel shortages in supervision departments remain a constraint to effective supervision.

Further Progress Required

The LDCs have made a start in implementing financial reforms in order to foster the development of more efficient and prudently managed financial sectors. Progress has been made in removing distortionary allocative controls and in enacting new financial legislation to strengthen prudential regulation, while many LDCs have also begun to restructure government-owned banks. Reforming the financial sectors in LDCs is, however, an ongoing task and a great deal remains to be done.

PART ONE

THE LEAST DEVELOPED COUNTRIES IN THE MID-1990S

PART ONE

The Least Developed Countries in the mid-1990s

I. The World Economic Setting and the LDCs

A. Introduction

The latest estimates of world output indicate growth of 2.6 per cent in 1995. This is below the growth rate recorded in 1994 and also the forecast for 1995 growth made earlier in the year, reflecting in the main the lower than expected growth in industrial countries. There were further improvements in the performance of some of the transition economies of Central and Eastern Europe, which recorded strong growth in 1995, and a deceleration in the decline of the economies of the Commonwealth of Independent States (CIS). Asian developing countries continued to record strong growth and there were also indications of an improvement in many African economies.

World trade expanded at about 9 per cent during 1995, marginally less than the strong growth attained in the previous year. Non-fuel commodity prices, which had risen sharply in 1994, remained generally buoyant in 1995. On the currency markets, the US dollar depreciated sharply against the yen in the first half of the year but recovered in the second half. Inflationary pressures remained subdued allowing monetary policies to be relaxed in many of the major industrial countries, with the consequence that nominal interest rates were at their lowest for many years, although in real terms the current level of interest rates is not low by historical standards.

Table 1: Region-wise economic performance of LDCs in 1980-1994, estimates for 1995 and forecast for 1996

(Percentage change of real output)

Country group	*1980-1990*	*1990-1994*	*1995*[a]	*1996*[b]
	(Annual average)			
Least developed countries	2.2	2.0	3.2	3.2
of which:				
LDC Africa	1.9	0.6	2.2	2.1
LDC Asia	3.1	3.9	4.6	4.8
LDC other[c]	0.4	-1.4	2.0	1.7
Memo items:				
World	2.9	1.6	2.6	3.0
Developed market economies	2.8	1.5	2.4	2.5
Developing countries[d]	2.8	3.9	4.3	5.0
Central and Eastern Europe[e]	2.1	-11.4	-2.0	2.0
China	8.8	10.8	10.0	9.0

Source: UNCTAD secretariat calculations based on national and international statistics.

a Estimates.
b Forecast.
c Haiti, Kiribati, Samoa, Solomon Islands, Tuvalu and Vanuatu.
d Excluding China.
e Including the former USSR.

B. Industrialized countries

There was a slow-down in the industrialized economies during 1995, with output growth rates not as high as had been anticipated at the start of the year. The average GDP growth rate of the 25 OECD countries was estimated at 2.4 per cent in 1995 compared to 2.9 per cent in 1994. Inflationary pressures have been subdued with inflation remaining at modest levels in most of the industrialized economies: the average inflation rate in the industrialized countries in 1995 was 2.5 per cent. However, high levels of unemployment, much of it "structural" in character, have persisted throughout Western Europe and North America. Unemployment rose in Japan, albeit from a much lower base than in other industrial countries. In the larger economies -- Germany and Japan and to a lesser extent the United States -- monetary policy was eased during 1995 and interest rates lowered.

Economic growth in the European Union (EU) declined only marginally -- from 2.8 per cent in 1994 to 2.7 per cent in 1995. Growth in Europe has been driven mainly by the strong demand for exports and inventories, although both sources experienced a slackening of demand in the second half of the year, especially in Germany and France. Consumer expenditures have been restrained throughout Western Europe because of high unemployment (the average share of the labour force without work in the EU was 10.9 per cent in 1995), while most EU governments have been striving to tighten fiscal policy in order to meet the budgetary convergence criteria for entry into the planned single currency.

Economic performance among the individual EU member countries varied, reflecting, *inter alia*, the different stages of the economic cycle which their economies had reached, and the impact of developments in foreign currency markets. In 1994, the German economy had recovered strongly from recession, recording a growth rate of 2.9 per cent, but the strength of the deutsche mark contributed to the slow-down to 1.9 per cent in 1995 and led the Bundesbank to lower interest rates: the official discount rate was at its lowest since 1959. In France, however, monetary policy was tightened in mid-1995 in response to speculative pressure on the franc, but was eased later in the year. Strong export demand helped to sustain the momentum of the French economy, with the growth rate falling only marginally from 2.9 per cent in 1994 to 2.7 per cent in 1995. Proposals by the French government to reduce public expenditure in order to meet the Maastricht convergence targets for the single European currency provoked widespread industrial unrest at the end of the year. In the United Kingdom, where the economic cycle is at a more advanced stage than in mainland Europe, growth slowed markedly in 1995 to 2.7 per cent from 3.8 per cent in the previous year. In Italy and some of the smaller EU economies, including Spain and Portugal, growth rates accelerated during 1995 under the stimulus of currency depreciation.

Although the current expansion in the United States began almost five years ago, the growth rate of the economy in 1995 was still higher than that attained in Europe, in spite of its deceleration to 3.3 per cent from the 4.1 per cent recorded in the previous year. The rapid growth in 1994 had exerted pressure on both capacity and labour markets and prompted a tightening of monetary policy towards the end of that year. There was a small reduction in interest rates in June 1995. The dollar depreciated sharply in the first half of the year, particularly against the yen, but it appreciated later in the year in response to the lowering of interest rates in Japan.

The stagnation of demand in Japan proved more persistent than had been anticipated with output growth during 1995 limited to 0.5 per cent, and a rise in unemployment to 3.5 per cent of the workforce. The failure of the Japanese economy to recover more vigorously, despite a fiscal stimulus and a lowering of interest rates (the Japanese discount rate was cut to 0.5 per cent in June), is attributable to the strength of the yen, especially in the first half of the year, and in particular to the effects of the depressed level of asset prices and the associated crisis in the country's banking system. Japanese banks have incurred losses from bad debts estimated at between 11 and 17 per cent of the GDP, and this has led to a credit squeeze in the business sector. The appreciation of the yen put severe pressure on the competitiveness of Japanese traded goods. The yen depreciated in the second half of the year as a result of the reduction in Japanese interest rates and coordinated intervention by the major economies in the currency markets.

C. Transition economies

There was further improvement in the performance of many of the transition economies during 1995, particularly those in Central and Eastern Europe and the Baltic states. Central and Eastern European economies are estimated to have grown at a rate of just over 4 per cent in 1995, the second consecutive year of strong growth, while the Baltic states recorded growth estimated at 2.4 per cent. The transition towards market economies is now well advanced in these countries. The Russian economy and other CIS economies continued to contract, although the pace of decline decelerated. The economy of the CIS as a whole declined by an estimated 5 per cent in 1995, compared to a fall of 14 per cent in the previous year. The figures should, however, be treated with much caution as a large unrecorded informal economy has emerged in these countries. The stabilization policies implemented in Russia made some progress during 1995, with a steep decline in the rate of inflation, although it remains high.

D. Developing countries

Growth in developing countries (DCs) remained strong in 1995, averaging 4.3 per cent (or 5 per cent including China), a rise of 0.6 percentage points from the previous year, but there were wide regional differences in economic performance. As has been the case for the past decade, the most dynamic region of the developing world was South and East Asia. Most DCs in this region continued to expand at a robust pace: growth averaged 7.1 per cent in 1995 -- a small rise from the previous year's growth. The appreciation of the yen provided a strong inducement to the region's DCs to expand their exports (their exports became more competitive *vis-à-vis* Japanese exports), while the strength of private-sector investment also contributed to the buoyancy of their economies. The Asian DCs also continued to attract strong capital inflows, despite the turbulence in other emerging markets, and this helped to maintain impressive investment levels, although it also exerted pressure on domestic demand which may prove excessive in some countries. In particular, external current account deficits have widened and inflationary pressures increased. As a consequence, a less expansionary macroeconomic stance may have to be adopted by several countries in the region to bring growth rates of output and demand down to more sustainable levels.

China's growth, which is estimated at 10 per cent during 1995, has been driven by rapid increases in exports and industrial output. The Republic of Korea achieved growth of over 9 per cent, Thailand more than 8 per cent and Indonesia 7 per cent during 1995. The Indian economy lagged behind those of many other Asian countries during the 1970s and 1980s, but the economic-policy reforms implemented in India in recent years have started to lift growth rates closer to the regional average: output in India rose by an estimated 5.9 per cent in 1995 -- a small increase over the previous year's growth.

African economies displayed significant improvements during 1995, reflecting the favourable trends in the international economy, specifically higher commodity prices, the impact of economic reforms, and the ending -- or at least cessation -- of prolonged civil conflicts in several countries. Preliminary estimates of output in Africa indicate growth of around 3.0 per cent in 1995, a rise from the 2.6 per cent estimated for the previous year, and the first time in more than a decade that growth of real output has exceeded that of population. The improvement was greater in sub-Saharan Africa (SSA): growth of 5.0 per cent is estimated for 1995 compared with only 2.1 per cent in 1994. However, a sustainable recovery in Africa still faces the constraints arising from the very high debt burden.

An important stimulus to recovery in Africa was provided by buoyant export prices and increased export production. Most African countries experienced substantial improvements in their terms of trade during 1994-1995 as a result of higher world commodity prices for tropical beverages, agricultural raw materials such as cotton, minerals and metals. Moreover, many African countries were also able to expand the volume of production, not least because trade and exchange-rate reforms have enhanced price incentives for exports.

Two of the strongest performers during the year were Côte d'Ivoire and Uganda: in both countries growth rates of over 6 per cent were forecast during the year. South Africa experienced an acceleration of growth from 2.3 per cent in 1994 to 3.0 per cent in 1995, although this is still below the levels needed to generate the jobs and incomes which would enable a significant reduction in unemployment and poverty to be achieved. The economy of Nigeria, the region's most populous country, continued to experience severe difficulties, with slow growth and high inflation, not least because of political instability and the lack of consistency in economic policy-making.

Growth rates were lower than had been anticipated in a number of countries, as a result of, *inter alia,* severe drought in North and Southern Africa and the disruptions caused by ongoing wars and political disturbances. The Food and Agriculture Organization (FAO) estimated that drought and civil conflicts threatened the food security of around 23 million people in SSA. The region of the developing world which experienced the lowest growth during 1995 was Latin America and the Caribbean. Economic growth averaged only 1 per cent, lower than had been forecast earlier in the year, and a sharp drop from the 4.4 per cent recorded in 1994. The main reason for the disappointing performance of the region was the Mexican financial crisis, which began at the end of 1994 and entailed a sharp reversal of external capital flows and a fall in the exchange rate. Mexico was provided with $50,000 million of international loans to support its economy as a result of the financial crisis and also initiated tough stabilization policies. The Mexican economy itself is estimated to have contracted by 6 per cent during the year. The Argentinean economy also suffered from a reversal of capital inflows as confidence in the region's economies on international financial markets was shaken. Brazil, Chile and Colombia, however, experienced strong growth during the year.

E. LDCs

Following a long period of relatively low GDP growth rates, which in most instances translated into declining per capita incomes, the LDCs growth performance has improved markedly in 1995 and is forecast to continue to improve this year (table 1). The output expansion is broad based and across all regions. The most notable feature, however, is the marked improvement in the performance of LDCs in Africa. From an average growth rate of less than 0.6 per cent recorded over the period 1990-1994, their output growth is estimated to have increased to 2.2 per cent in 1995 and is expected to continue into the present year. The Asian LDCs continue to record a marked upsurge in their development performance over the 1980s. In fact, in the 1990s, their growth rate is significantly higher than the world average and approximates the averages recorded for all developing countries. The series of macroeconomic indicators presented in table 2 likewise suggest evidence of clear improvements in macroeconomic performance in critical areas, such as overall trade growth and in current account and fiscal balances.

Africa

The economic performance of the African LDCs, like that of the region as a whole discussed above, was mixed in 1995, although improvements in GDP growth rates are expected to have occurred.

Several countries experienced reasonably strong growth during the year and were able to attain increases in per capita output. The acceleration of growth in these countries was due to a combination of the improved economic policies put in place over the course of several years, favourable weather, which facilitated good harvests, and buoyant export prices. But in a significant minority of LDCs, civil conflict and political instability continued to impede economic recovery and impose enormous suffering on their populations.

The external trading environment for most African LDCs improved substantially during 1994 and 1995, in particular due to the rise in world prices for coffee and cotton, which are the major export earners for many countries in this group. Benin, Burundi, Chad, Malawi, Mali, Togo, Uganda and Zaire were among the LDCs which benefited from the largest rises in their external terms of trade. Higher commodity prices boosted export earnings and provided an important stimulus to growth in many LDCs. The improvement in the terms of trade is, however, likely to be temporary, as commodity price booms have historically been short lived, and world prices for beverages in particular are forecast to decline steeply over the next two years.

The impact of policy reforms such as exchange-rate devaluation, trade liberalization and the provision of improved producer prices for

Table 2: LDCs' selected economic indicators, 1990-1995[a]
(Percentages)[b]

	1990	*1991*	*1992*	*1993*	*1994*	*1995[c]*
Real GDP	2.1	0.6	1.0	3.3	3.2	3.2
Memo: World	2.1	0.2	1.2	1.7	3.1	2.6
Exports value (f.o.b.)	1.9	2.5	-3.8	4.2	13.4	15.3
Imports value (f.o.b.)	9.9	0.5	6.1	2.9	4.6	11.8
Current account[d]	-37.0	-40.6	-42.1	-39.9	-31.6	-29.2
Debt-service ratio[d]	27.4	22.9	17.0	17.2	17.2[c]	20.2
Ratio of external debt to GDP	70.0	62.8	74.0	72.0	76.0[c]	78.0
Central government fiscal balances[e]	-8.3	-7.5	-7.8	-7.3	-7.8	-7.0
Broad money aggregates[f]	30.7	62.5	60.4	48.1	46.4	28.8
Non-fuel commodity prices[f]	-4.1	-6.3	-9.1	-1.6	29.4	10.9

Source: UNCTAD secretariat calculations based on data from IMF, the World Bank and the OECD secretariat.
a Without Angola, included in the group in 1994.
b Growth rates, unless otherwise stated.
c Estimates.
d In percentage of exports of goods and services.
e In percentage of GDP.
f Annual percentage change.

farmers has started to bring tangible benefits to a range of African LDCs. The recovery in Uganda has been under way since the late 1980s and it is again expected to record robust growth in 1995, with the coffee price boom providing an additional stimulus. The Mauritanian economy has revived since the early 1990s and is forecast to attain growth of over 4 per cent in 1995. Other countries in which GDP growth is expected to be relatively robust in 1995 include Ethiopia, Lesotho and Mali. The devaluation of the Communauté financière africaine (CFA) franc in January 1994 and the associated inflows of financial assistance have provided a stimulus to the economies of those LDCs that are members of the CFA currency zones.

Good weather in parts of the region boosted agricultural output in several countries including Sudan, but some of the LDCs in Southern Africa, such as Malawi and Zambia, were badly affected by drought.

Although growth rates of output picked up in 1995, major macroeconomic imbalances, especially those arising from unsustainable government deficits, continued to jeopardize economic stability in many LDCs in the region, including Malawi, the United Republic of Tanzania, Zaire and Zambia. Excessive fiscal deficits have led to steep rises in interest rates, as governments have attempted to borrow from shallow domestic financial markets, high rates of inflation and depreciating exchange rates. These, in turn, are a serious deterrent to the private-sector investments which are essential if sustainable growth is to be achieved in the region.

There are signs of a revival in the fuel and minerals sectors of African LDCs, with several major projects planned or already under way: these include projects for oil in Angola, gold in Mali and copper in Zambia.

Civil conflicts and political instability have been the major impediment to economic recovery in around one third of the African LDCs. In a number of countries, including Angola, Liberia and Mozambique, prolonged conflicts have at last been halted, a prerequisite if reconstruction and development are to begin. In others, such as Burundi, Rwanda, Sierra Leone, Somalia and Sudan, conflicts have not been resolved and their consequences have been devastating. Both Burundi and Rwanda experienced large declines in real GDP in 1994, while in Sierra Leone the continuing rebel attacks during the last four years seriously affected agricultural and mining output. Endemic political instability also affected other LDCs, notably Zaire. The government of Sao Tome and Principe was overthrown in a military coup, while in Comoros, a coup led by a French mercenary was thwarted by the intervention of the French military.

Box 1: Possible explanations for the diverse economic performances of individual LDCs

The economic performance of the LDC group over the last decade and a half has been poor. Across the entire LDC group, per capita output declined at an annual rate of 0.3 per cent during the 1980s and 1.9 per cent during 1990-1993. The per capita growth rates of the LDCs lagged behind those of DCs: moreover, while the performance of the latter has improved during the 1990s, that of the LDCs has deteriorated.

However, the average growth rates mask considerable differences between the economic performances of individual LDCs. Three broad groups of countries can be identified with respect to their economic performance.

First, a relatively small group of 10 to 12 LDCs has achieved impressive growth rates and, as a result, has been able to make significant progress in raising living standards. These countries are referred to below as the strong-growth LDCs.

Secondly, a larger group, referred to below as the low-growth LDCs and comprising approximately 21 countries, of which around 17 are in sub-Saharan Africa, has suffered a stagnation of economic growth since the early 1980s.

For a third group of around 15 LDCs (almost one third of the countries in the LDC group), economic and social development has been severely retarded by widespread and acute civil disorder.

The table provides details of the per capita growth rates of these three groups. The allocation of countries to the third group is to some extent a matter of judgement. There is no clear-cut dividing line between countries afflicted by civil disorder and political instability and those which are not, partly because such characteristics are not readily amenable to quantification and partly because the political and security situation in these countries is fluid.

Strong-growth LDCs

Ten LDCs have achieved increases in real per capita incomes of around 2 per cent per annum since the start of the 1980s. They are Bhutan, Cape Verde, Chad, Guinea-Bissau, the Maldives and the Solomon Islands, with Bangladesh, the Lao People’s Democratic Republic, Lesotho and Nepal being borderline cases. Tuvalu grew very strongly in the 1990s but no data are available prior to 1989, while Botswana’s economic growth has been so rapid since the 1970s that it was graduated from the LDC group at the start of 1995. These countries attained an average GDP per capita growth rate of 2.7 per cent during 1980-1990 and 1.7 per cent in 1990-1993.

In terms of economic structure, size, geography and demography, these countries vary widely, although two thirds are located in Asia or the Pacific and have probably derived substantial benefits in terms of trading opportunities and foreign investment from the rapid economic growth elsewhere in the region. What the strong-growth LDCs appear to have in common is that they have avoided serious civil conflict during the last decade and a half (Chad is a partial exception). Most have followed relatively prudent macroeconomic policies, have avoided excessive rates of inflation and have not accumulated unsustainable levels of external debt.

With the exception of Chad, none of the strong-growth LDCs has been heavily dependent for export earnings on primary commodities (e.g. coffee, cocoa, cotton) which have experienced severely depressed prices on world markets over the last decade. Their major exports have instead comprised, for example, fish products, diamonds and garments. Partly because of this, they have achieved relatively strong export growth: their export values in dollars expanded at a rate of 8.3 per cent per annum between 1980 and 1993 compared to the LDC average of 1.8 per cent.

Many of the strong-growth LDCs have also attracted substantial inflows of foreign exchange in the form of remittances from their nationals working abroad or from high per capita levels of ODA. The strength of their export earnings and other foreign-exchange inflows has enabled them to finance an expanding volume of imports: their annual import volume growth rate was 6.0 per cent compared to an LDC average of 0.3 per cent between 1980 and 1993. The strong-growth LDCs were thus able to avoid the import compression which has retarded production and investment in other LDCs.

The island economies are a somewhat distinct subgroup of the strong-growth LDCs and share a number of characteristics which are atypical of LDCs. Because they have very small populations, ODA per capita tends to be very high and this has helped to finance investment expenditures which are very large in relation to GDP. Most of the strong-growth island economies have per capita income levels equivalent to those prevailing in middle-income DCs; they have also attained much greater levels of human and social development, especially in terms of health and education.

Box 1 (concluded)

Low-growth LDCs

Almost half of the LDCs fall into the low-growth category which, on average, suffered annual declines in per capita GDP, averaging 1.3 per cent during 1980-1990 and 0.3 per cent during 1990-1993. Falling per capita output and declining terms of trade have led to a significant reduction in living standards in most of these countries. Their poor economic performance cannot be attributed to the effects of civil conflicts as all have avoided serious civil strife during the last decade. This group of countries epitomizes, in many respects, the development problems facing the LDCs: output growth has failed to keep pace with population growth over a sustained period of time, export earnings have stagnated leading to chronic foreign-exchange shortages, poverty has intensified and structural change has been minimal.

Although the factors responsible for retarding their development are not identical, they share a series of major problems and constraints, including a heavy reliance on primary commodities, the world market prices of which have been depressed since the 1980s, rapid population growth, and a series of deep-seated structural constraints relating, *inter alia,* to low levels of human-resource development, rudimentary technology, especially in agriculture, and weak private sectors. Poor economic policies also made a major contribution to their economic problems, although most of the countries in this group have implemented economic-reform programmes in recent years designed to redress the policy errors.

Civil strife and war-affected LDCs

Civil strife and acute political instability have afflicted about one third of the countries in the LDC group over the course of the last decade with devastating effects on their economies and on the health and living standards of their populations. Per capita output in these countries fell by 1.0 per cent per annum during 1980-1990 and 5.7 per cent per annum during 1990-1993, but these figures probably understate the economic damage caused by civil strife in these countries. Infrastructure has been destroyed, causing severe problems for transport, communications and utility supplies. Agricultural production has collapsed in many countries as the rural population flees the war-afflicted areas, undermining food supplies and creating refugee problems for neighbouring countries. Civil conflicts have been the dominant influence on the economic performance of this group of LDCs. Ending these conflicts and restoring some form of functional government able to command support from the majority of the population are absolute prerequisites if the development process is to begin again.

Table: Growth rates and per capita income of LDCs, 1980-1993[a]

Country groups	*Real annual GDP growth per capita (%)*		*GDP per capita (1993 $ prices)*	
	1980-1990	**1990-1993**	**1980**	**1993**
Group A	2.7	1.7	491	685
Group B	-1.3	-0.3	533	462
Group C	-1.0	-5.7	339	264
All LDCs	-0.3	-1.9[b]	493	456
All DCs	1.2	1.8	828	984

Source: UNCTAD database.
Note:
Group A: Strong-growth LDCs (12): Bhutan, Botswana, Cape Verde, Chad, Guinea-Bissau, Maldives, Solomon Islands, Bangladesh, Lao People's Democratic Republic, Lesotho, Nepal and Tuvalu;
Group B: Stagnant LDCs (21): Benin, Burkina Faso, Central African Republic, Comoros, Djibouti, Equatorial Guinea, Gambia, Guinea, Kiribati, Madagascar, Malawi, Mali, Mauritania, Myanmar, Niger, Samoa, Sao Tome and Principe, Uganda, the United Republic of Tanzania, Vanuatu and Zambia;
Group C: Civil strife and war-affected LDCs (15): Afghanistan, Angola, Burundi, Cambodia, Ethiopia, Haiti, Liberia, Mozambique, Rwanda, Sierra Leone, Somalia, Sudan, Togo, Yemen and Zaire. The data for these countries may suffer an upward bias because data are missing for some of the worst afflicted countries.
a Averages are unweighted.
b Different from the figure in table 6 (chap.II) because of the inclusion of Botswana (in group A), which graduated from the LDC group in 1994; and exclusion of Eritrea (from group C), which was administered as part of Ethiopia for the relevant period.

Asia

Economic growth in Asian LDCs decelerated slightly in 1994 to 4.0 per cent from 4.2 per cent in 1993, and in 1995 was estimated to have increased to 4.6 per cent. This pattern of overall GDP growth in 1994 would have been much higher had it not been for the adverse performances of Afghanistan and Yemen, where continued military conflicts drastically affected output. If these two countries had been excluded, the remaining countries would have shown significant improvements in GDP growth to 5.3 per cent in both 1994 and 1995.

Significant progress in GDP and per capita GDP growth has been observed in more than half the Asian LDCs in recent years. This was made possible due mainly to government efforts to open up their economies by emphasizing private-sector initiatives, encouraging foreign-capital inflows and setting up export-processing zones, as well as maintaining realistic exchange rates and low inflation rates. Trade liberalization and a favourable regional environment for enlarged production facilities through cooperation in trade and investment with neighbouring countries, particularly in South-East Asia, were also key factors in the expansion of the Asian LDCs' economic activities. For example, GDP growth in the Lao People's Democratic Republic, which increased by 8 per cent in 1994 to an estimated growth of 7 per cent in 1995, will likely continue well into 1996. In Bangladesh, economic activities increased in 1994 to 4.6 per cent, higher than in the previous year, and were expected to exceed 5 per cent in 1995. Continuing its upward trend, Myanmar's GDP growth of 6 per cent in 1994 was followed by a marginally higher increase in 1995. Thus, it was estimated that six of the nine LDCs in Asia grew by more than 5 per cent during 1995.

While significant shifts of production away from agriculture took place in many countries (for example, in Bangladesh the share of agriculture fell from 41 per cent of GDP in 1980 to 30 per cent in 1994), the industrial sector still accounted for only around 17 per cent on average in 1993, except for Bhutan, which attained 29 per cent. Though industrial growth remained relatively high, rising in recent years to about 9 per cent in Bangladesh and Cambodia and more than 10 per cent in the Lao People's Democratic Republic and the Maldives, together with manufactured goods exports on an upward trend, industries continued to be highly concentrated on a few items. For example, ready-made garments in Bangladesh and in the Lao People's Democratic Republic, carpets in Nepal and assembled motorcycles in the Lao People's Democratic Republic accounted for a large share of exports.

Despite serious efforts to diversify trade, it appears that only modest progress has been achieved. Due to domestic production constraints, LDCs are heavily dependent on imported inputs for their export sector. In the area of ready-made garments, they need to improve their competitiveness, particularly in enhancing quality and design towards higher value-added products and ensuring the development of a network of business contacts. The development of vocational training centres is of prime importance to accelerate output and create jobs.

Several LDCs, such as Bangladesh, the Lao People's Democratic Republic and Myanmar are endowed with rich and diversified natural and mineral resources and are beginning to attract significant foreign direct investment that leads to joint ventures in various sectors from agriculture to improvements in infrastructure. Opportunities also exist in countries such as Cambodia, Myanmar and Nepal to promote tourism and to enlarge the range of non-traditional products where they have comparative advantage. Myanmar made efforts to promote 1996 as the "Visit Myanmar Year". Fisheries, which represented a significant source of earnings for some countries such as Bangladesh and the Maldives, could be enhanced towards higher value-added products through domestic processing. Despite serious constraints, Bhutan made impressive gains with the hydropower potential offered by its mountainous terrain. Bangladesh, with its huge reserves of natural gas, has plans for improved energy distribution. Increases in cotton output (a new crop) are expected to reduce the demand for imported cotton in the textile and garments industry. Myanmar, which has a large agricultural base, is particularly rich in a wide range of minerals and has a growing energy sector, including natural gas and hydroelectricity generation for exports.

Since agriculture continues to be the LDCs' mainstay, employing a large part of the labour force, and is the source of much of the industrial sector's inputs; any mishap resulting in poor agricultural performance would have serious implications for the LDC economies as a whole. A good agricultural performance in the Lao People's Democratic Republic and Nepal during 1994, as well as a recovery in the rice harvest in 1995 in Cambodia, has enabled large sections of the population to benefit from low food prices and has helped them to maintain low inflation rates. Stimulated by the recent strengthening of world commodity prices, countries such as Cambodia, the Lao People's Democratic Republic, the Maldives and Myanmar have improved their 1994 export performance with value increases ranging between 31 and 43 per cent over the previous year. Encouraging results were also expected for 1995.

In recent years, most Asian LDCs have made serious efforts to implement wide-ranging programmes of policy reforms to reduce macroeconomic imbalances through fiscal, monetary and administrative measures. Many of their constraints are structural and are not easily reduced in the short term. High population density (up to 800 persons per square kilometre in Bangladesh and the Maldives for instance), lack of infrastructure and human resources, and falling or stagnating assistance impose difficulties on the productive sectors. Other factors including recurrent natural disasters, falling commodity prices and debt-service payments, which are beyond the control of policy makers, continued to hamper GDP growth and worsen the living conditions of the poor. This situation is even more acute for land-locked countries that have to bear high transportation and transit costs for their traded goods.

However, the pace of reforms contrasted with varying results. While significant overall progress had been made in achieving relative macroeconomic stability and growth, certain countries continued to lag behind in implementing their development process. Indeed, LDCs that succeeded in reviving GDP growth were generally those that had progressed towards political stability and economic management. In countries such as Afghanistan and Yemen, military conflicts have resulted in considerable losses and huge financial costs. The paucity of both financial and technical resources have hampered development efforts, and, together with recurrent violence and fighting, have seriously jeopardized the establishment of a durable peace for sustained recovery.

High savings and investment rates are needed to improve supply capacity in order to sustain rapid economic development. Though there have been some improvements in domestic savings in recent years in a few countries, about 17 and 12 per cent of GDP in Bhutan and Myanmar, respectively, they remained relatively low -- in most cases below 10 per cent. Greater efforts are required to strengthen capital markets with liquidity for financing private investment. On the other hand, private remittances from nationals living abroad also were an important external source of foreign earnings for some countries, e.g. in Bangladesh, they were as high as 49 per cent of its value of merchandise exports in 1994. Though these flows are useful in financing current account deficits, their long-term sustainability may raise concern. Nevertheless, gross domestic investment rates, supported by external financing, remained generally high, particularly in Bhutan, the Maldives and Nepal. The interests of local businessmen need to be sustained through innovative measures that translate economic activities into higher output.

Undoubtedly, privatization has made some progress in many LDCs. But the pace of progress has been periodically hampered, mostly by labour unions. Large losses incurred by State enterprises continued to deplete the budget, depriving governments of the resources needed for generating activities in crucial areas including infrastructure, energy development and social services. The performance of private enterprises could be improved if the public sector provided necessary inputs and access to required support services. Sluggishness to address LDCs' problems will only perpetuate past trends and loss of confidence.

Pacific Islands and Haiti

The economic performance of the LDCs in the Pacific Islands has been less satisfactory than that in Asia. They generally experienced low GDP growth rates, attaining on average only 1.2 per cent in 1994, with real declines in Kiribati and Samoa. Despite higher world commodity prices, agricultural output (particularly copra) fell substantially in the Solomon Islands and Vanuatu as a result of unfavourable weather conditions. In 1995, little improvement was expected because their difficulties were further constrained by the resumption of French nuclear testing in the South Pacific, which affected fishing and tourism.

This situation was due, to a large extent, to their small size and remote location, high vulnerability to natural disasters, infertile soil (particularly in Kiribati and Tuvalu), a narrow production base and diseconomies of scale, and heavy reliance on natural-resource based products and services. Many countries had high population growth rates and some of them resorted to emigration in order to maintain a lower net population growth rate. The pattern of slow and uneven GDP growth could also be attributed partly to persistent high negative domestic savings rates in all countries except Vanuatu, reflecting high propensities to consume, and thereby poor private investment in the productive sectors of the economy. In addition, the potential of the tourism sector has not yet been fully exploited in many Pacific Island

LDCs. Inadequate supplies of potable water, insufficient investment in hotels and recreational facilities and, above all, infrequent air service have greatly hindered the flow of tourists. Nevertheless, earnings from tourism were generally larger than those of merchandise exports in countries such as Samoa, Tuvalu and Vanuatu.

The persistent trade account deficits have continued to worsen since the early 1990s in all countries because of the difficulties in expanding and/or diversifying exports. Only the Solomon Islands has made some improvements, mainly through its increased rate of log exports. While copra and coconut products remained the major export items in several LDCs, accounting for some 45 per cent of total export earnings in Kiribati and Samoa, some progress has been made in Vanuatu with beef and cocoa exports increasing rapidly. However, imports (including foodstuffs) have far exceeded exports, for example, by more than 10 times in Kiribati and Tuvalu. But there are opportunities to expand trade and services in regional markets. The proximity of the Pacific Island LDCs to the dynamic neighbouring countries of Asia, where rising incomes are sustaining demand for niche food products (seafood) and leisure travel, may provide new perspectives for LDCs' natural resources.

Despite the poor performance of domestic savings, gross domestic investment rates (supported by external savings mainly from aid inflows) remained high and were used largely to finance development expenditures. For some countries, private remittances also were an important source of earnings, particularly in Samoa where the 1994 level was four times higher than that of merchandise exports, or about twice the level of official transfers. While the flow of foreign direct investment to some LDCs, such as

Box 2: Recent economic developments in Haiti

Haiti continues to be the poorest of the Western Hemisphere countries with an estimated per capita income in 1994 of $250. More than 70 per cent of its estimated 6.7 million population live below the poverty line. The agriculture sector is characterized by low productivity and near-stagnant production so that per capita output has fallen steadily over the past few years. Given the stagnation in agricultural production, agricultural imports -- particularly food -- have soared.

In the broader context of the United Nations peace-keeping operations, the government has developed an Emergency Economic Recovery Programme aimed at undertaking urgent actions in key sectors. In addition to specific actions in the economic and social sectors, the Programme emphasizes the introduction and implementation of a new philosophy of governance that would shift the government's role from operating productive assets and directing industry and economic processes to that of monitoring, regulating, setting policies and standards and creating suitable conditions for growth and development. In the social sphere, poverty alleviation, education and health have emerged as priority areas. The donor community has expressed support for this approach. As a result of the improved domestic-policy environment and increased external support, the Haitian economy is expected to register positive growth in 1995 for the first time in six years. The outlook for further growth on a sustained basis remains upbeat as the foreign-exchange situation has improved. By the end of June, no less than $400 million of bilateral and multilateral commitments made since October 1994 have been disbursed. Such disbursements have been directed mainly towards balance-of-payment support, emergency imports, support for improved governance and humanitarian assistance. These areas have, of course, limited direct impact on employment creation and income generation. However, during the second half of 1995, this trend should be gradually reversed as close to $200 million will be spent with emphasis on other fields. Private investors who, by and large, remained cautious and took a "wait and see" attitude in view of the political uncertainty are now expected to respond positively. Though the security situation has improved since the arrival of the multinational forces in September 1994, concern regarding the rule of law remains high in the business community.

Development cooperation went through several hurdles as dialogue between the de facto government in power from the Coup d'Etat of September 1991 and the development partners ceased. With the restoration of the legitimate order in September 1994, dialogue and cooperation were revived through a series of meetings, needs-assessment missions and agreements on major development orientations. This process culminated in the Consultative Group Meeting of May that was attended at high level by key multilateral and bilateral donors. The Consultative Group has been instrumental in forging new partnerships between the legitimate government and its development partners. It provided the opportunity to clarify and articulate policies to deal with the socioeconomic issues facing Haiti and to set up priority actions and interventions as well as the level and type of the external support required and the modalities of coordination. As part of this coordinated approach, the Paris Club Meeting of 30 May 1995 agreed to renegotiate Haiti's bilateral official debt. It granted Haiti the recently introduced Naples terms and helped devise a debt strategy consistent with sustainable development. The arrangement, which included a 67 per cent debt reduction and a 23-year rescheduling for the remaining debt, was made possible by fulfilling the conditions of a $31 million stand-by agreement signed in March with the IMF. Haiti's total external debt at the end of 1994 stood at over $850 million owed largely to official creditors.

Vanuatu, has been concentrated mainly on the development of the tourism industry and offshore financial services, joint-venture participation in fisheries and forestry has been substantial in the Solomon Islands.

Prudent fiscal management has been the rule for most Pacific Island LDCs, resulting in a large public sector in the economy. However, the overall balance of government finance in Samoa and the Solomon Islands has deteriorated since 1990, with total public expenditures averaging, respectively, 73 and 55 per cent of GDP, which resulted in large imbalances and inflationary pressures. While in Samoa, the growth of expenditures reflected mostly the high costs of cyclone rehabilitation programmes due to a series of natural disasters, the expansion of wages and subsidies in the Solomon Islands' public sector was, to some extent, responsible for the high government debt. But despite efforts to manage their debt problems, the ratio of debt to GDP in these LDCs, except Tuvalu, increased substantially. In Samoa, the ratio was well above 100. Under various policy-reform programmes, provisions have also been made to enhance domestic savings and to liberalize their economies through private-sector participation in crucial areas such as trade, tourism and air services with a view to encouraging GDP growth.

To promote sustained long-term growth under difficult climatic conditions, i.e. natural disasters, Pacific Island LDCs are aware of the need to protect the environment when exploiting their natural resources. For this reason, they joined with other neighbouring countries and agreed to work towards a common code of conduct with a more judicious control on fishing and better forestry management.

In Haiti, shortages in electricity supply and slow progress in the disbursement of external aid already committed were hampering, in a large measure, the recovery of the economy which contracted by more than 10 per cent during 1994. Although new investment incentives have been announced, including simplified import and export procedures, as well as a substantial increase in the minimum wage rate, the Government's real challenge is the rapid implementation of development projects that can create employment and improve the overall infrastructure and living conditions (also see box 2).

F. World commodity prices

Since the second half of 1994, non-fuel commodity prices have risen sharply. The United States dollar price index of developing country non-fuel primary commodities rose by 18 per cent in 1994 over the level in the previous year. They increased by a further 9 per cent in 1995. LDCs' non-fuel commodity exports recorded even stronger growth in prices: prices rose by 29 per cent in 1994 and 11 per cent in 1995. This followed four successive years of sharp declines. The rise in commodity prices was brought about by a strengthening of demand on world markets due to a recovery in world economic activities, the relatively low level of stocks of many commodities, and buying of commodities by investment funds. The prices of some commodities were also boosted because adverse weather conditions reduced the supply from major producers.

The commodity boom during 1994-1995 was not evenly spread among all commodities, and certain commodities of export interest to LDCs did not benefit from the increase in prices. In 1994, there was a 113 per cent increase in coffee prices, while the prices of copper, copra, cotton and jute rose by between 22 and 41 per cent. However, the prices of commodities such as fish, tea and tobacco remained virtually stagnant. The depreciation of the United States dollar in the first half of 1995 also served to dampen the real value of the commodity price increases, as most commodity prices are denominated in dollars. Furthermore, the price rises which did occur took place on the free world markets, whereas many exporting countries had presold their products under contracts well in advance, and, consequently, derived little benefit from the price increases.

By the end of January 1995, investment funds selling back commodities onto the world market, together with increases in supply from previously idle capacity brought back into production, had begun to reverse the upward movement in some commodity prices, although the prices of most of the major commodity groups remained buoyant. Among the commodities of interest to LDCs, copper and cotton experienced the largest price rises in 1995, of 25 and 23 per cent, respectively. The price of copper was boosted by tight supply conditions and low stock levels. Production shortfalls of cotton and heavy demand from textile industries, particularly in Asia, sustained high cotton prices in the global market. However, in some countries, incentives given to farmers to further increase output could weaken prices in the second half of 1996.

There were mixed fortunes for tropical beverages in 1995. The price of coffee rose by a further 5 per cent because of the tight Brazilian supply situation, together with drought damage in Colombia and attempts to sustain prices through the implementation of an export-retention programme among producers. Although the high 1994 retail prices have dampened consumption demand and heavy roaster buying, stocks have been drawn down for three consecutive years. But increased production expected for the 1995-1996 crop due to new plantings coming on stream (mainly from Asia), and an output recovery in some African-producing countries, should lead to downward pressure on prices.

The price of tea on world markets fell by 15 per cent in 1995. Concerns about global oversupply of tea, due to stagnating demand and favourable weather conditions in the major exporting countries of Africa and Asia, prompted producers to institute tighter control over export standards so as to avoid further deterioration of tea prices.

Cocoa prices could drop in 1995-1996 with forecasts of a good West African crop and some recovery in Asian output. Moreover, there is a risk that larger supply availability could also come from a gradual disposal of buffer stocks. Lower expected output of coconut in 1996, mainly from the Philippines, should improve price prospects for copra. Jute prices continued to strengthen as the Green environmental movement's support for the fibre led to increased demand. Rising consumption of edible oils, together with lower production of oil-seeds expected for 1996 (except crude palm oil), would gradually strengthen most prices for edible oil.

Despite the recovery of commodity prices in 1994-1995, the prevailing level of real prices of most commodities was still well below the levels reached in the late 1970s and early 1980s. The terms of trade of these commodities declined by 37 per cent between 1980 and 1994, or by 3.2 per cent annually. The fall affected virtually all major commodity groups, with food products hit especially hard.

Table 3: Primary commodity prices for developing countries (excluding crude petroleum), 1980-1995

(Percentage change, annual average)

	1980-1990	*1990-1994*	*1995*[a]
All primary commodities	-2.3	1.8	9
Food	-3.6	3.4	4
Agricultural non-food	-1.2	1.1	15
of which:			
Coffee	-7.5	15.2	5
Copper	2.1	-3.7	25
Copra	-6.5	16.2	4
Cotton	-0.7	-3.1	23
Fish	1.6	0.4	-11
Jute	1.2	-4.0	5
Tea	2.4	12.9	-15
Tobacco	2.3	1.2	2
Real price of all primary commodities[b]	-5.3	2.1	3

Source: UNCTAD secretariat calculations, based on United Nations, Monthly Bulletin of Statistics.

a Estimates.

b Deflated by unit value index of manufactured goods exported by developed market-economy countries.

G. Short-term prospects for LDCs

Africa

The improvement in the economic performance of African LDCs observed in 1994-1995 should be sustained over the medium term: overall GDP growth of the group is forecast at about 2 to 3 per cent in 1996. Assuming a normal rainfall pattern, which will enable the agricultural production levels achieved in recent years to be sustained in a number of countries, the economic outlook of the group is largely dependent on the future of the world commodities market.

The commodities price boom is generally expected to weaken by mid-1996. A slow-down of GDP growth rates is forecast in the majority of countries which experienced a beneficial impact of the high international prices for the primary commodities. Exports of the major coffee (Ethiopia, Madagascar, Uganda) and cotton (the Central African Republic, Chad, Mali, Sudan) producers are likely to stagnate or even decrease because of the projected fall in prices of the respective commodities. Nevertheless, in Uganda, where the economic base is more diversified than in many other African LDCs, the fall in coffee receipts is likely to be made up for by receipts from non-traditional exports, and GDP growth is expected to exceed the targeted level.

Short-term prospects are reasonably good for the relatively large economies of Angola, Ethiopia and Mozambique, where the process of the post-war economic recuperation has been initiated. In Angola, the recovery of the oil sector, with a substantial rise in crude-oil production, accompanied by the projected rise in oil prices, may result in a large surge in the volume of exports, although acute balance-of-payment problems are likely to remain because of the huge debt overhang. The first signs of the recovery, though erratic, were observed in Mozambique in 1993, but the severe drought of 1994-1995 almost stopped the development and the reform process. Nevertheless, the return of normal climatic conditions should reinforce the development potential of the country's economy. In Ethiopia, the progress made by the government in implementing reforms in the last four years augurs well for the short-term growth prospects.

This rather optimistic outlook for the African LDC group is based on the assumption of stable aid inflows and timely and adequate debt-relief measures. Real GDP growth is likely to be directly boosted by the inflows of aid money channelled to the provision and rehabilitation of infrastructure, and the re-establishment of business confidence which is conditional, *inter alia,* on political stability, policy predictability and transparency and a continuation of unilateral liberalization.

Asia

Barring any unforeseen circumstances, the economic prospects of Asian LDCs as a group remain good, with the possibility of almost all countries resuming positive growth rates. While certain primary commodities may be able to maintain above average 1990-1993 prices and, perhaps, influence agricultural output positively, strong industrial activities are likely to be sustained in some countries, such as Bangladesh, the Lao People's Democratic Republic and Myanmar, through increased flows of foreign direct investment and/or enhanced trade with regional partners.

Nonetheless, the pattern of growth may remain somewhat uneven among countries. Without a durable peace in Afghanistan, national reconstruction will prove to be difficult. In 1996, Bangladesh's GDP growth may expand steadily by more than 5 per cent, with industry making a strong contribution as foreign direct investment continues to rise and agricultural output resumes its usual growth rate following the poor rice harvest last season. In Cambodia, improved internal stability combined with falling inflation rates from over 100 per cent in 1993 to an expected single digit figure, stemming in part from the stability of the local currency, may be necessary to encourage foreign investment in hotel and garment projects. The Lao People's Democratic Republic's good commercial relations with neighbouring countries may, hopefully, attract new foreign interest in the hydroelectric sector for the expansion of electricity exports as well as in the textiles and clothing sector. GDP growth rate in the Maldives is likely to be hindered in the short term by the curtailment of public expenditures in order to improve the budgetary situation.

In Myanmar, recent improvement in the political situation is likely to ease international pressure on the economy and encourage larger inflows of tourists, construction of more foreign-funded hotels and improvements in transportation services. Less enforcement of government regulations concerning the private sector is likely to contribute to the expansion of agriculture. The continuation of these positive developments may, however, depend on how the transition to democratic rule is managed.

The repeat of the high growth of 6.8 per cent observed in Nepal during 1994 seems rather unlikely in the immediate future because of declining exports of carpets and garments. In Yemen's war-damaged economy, GDP growth may increase in line with the slow rise in crude-oil production. Inflation is likely to remain at a high level following the 1995 devaluation of the local currency as part of reforms which include cuts in subsidies and privatization of much of the non-oil sector.

The performance of the export sector, which is expected to remain generally encouraging, may positively influence the trade balance in many Asian LDCs. However, instances of a probable widening of a merchandise trade gap, caused by rapid growth in import demand of capital goods, due to higher investment spending from foreign investors, may occur in Bangladesh and in the Lao People's Democratic Republic. Trade deficits, resulting mainly from a strong growth of fixed capital formation in productive sectors, may prove beneficial for securing the sustained expansion of GDP.

II. Recent Trends in External Finance and Debt

Introduction

As regards all developing countries, the first half of the 1990s has been characterized by an upsurge in capital inflows and by a change in the composition of these flows, with the net flow of official development finance decreasing in relative importance. While the resource flow was earlier dominated by official flows and commercial bank lending to public-sector borrowers, the recent increase has largely taken the form of private direct investment and portfolio flows to private-sector borrowers. At the same time as LDCs have been affected by the stagnation in official development assistance (ODA), they have captured little of the increase in private flows.

Many of the LDCs are debt-distressed and have adopted a policy of refraining from new borrowing on non-concessional terms. The private sector in general is still weak in these countries. These factors can be expected to limit more diversified external financing. At least over the short- to medium-term and until such time as their growth prospects significantly improve and their current debt problems are resolved, it is likely that the LDCs as a group will remain at the margin of global capital markets. Paradoxically - as noted below - they even seem to be at risk of marginalization with regard to ODA. Together, these trends - overall ODA scarcity, a shrinking part of it going to the LDCs and their continuing high debt-servicing burden - threaten to seriously diminish the net transfer of resources to these countries.

A. Total resource flows and net transfer of resources to LDCs

In terms of net flows, the scale of non-ODA financing to the LDCs is currently modest. The net inflow of official resources other than ODA was relatively more significant in the mid-1980s (annex table 15), but it started to contract in the latter half of that decade as LDCs' debt problems and need for primarily concessional finance became apparent and the international financial institutions shifted to mainly concessional finance in their lending to LDCs. In 1994, other official flows from DAC sources (i.e. from countries members of the Development Assistance Committee of OECD (DAC) and multilateral agencies mainly financed by them) to the LDCs as a group amounted to some $0.2 billion on a net basis. Meanwhile, there has been a substantial net outflow on private export-credit account throughout most of the past decade. Other private flows have remained limited for most LDCs. The bulk of the inflows from DAC sources in recent years has consisted of transactions with Angola and Liberia. Net direct investment and other private flows, excluding export credits, to LDCs other than these two countries averaged only $0.1 billion in 1993-1994, as recorded in OECD/DAC statistics.

However, there is likely to be underreporting of actual foreign direct investment (FDI) inflows to LDCs in OECD/DAC statistics, if only for the reason that the latter record FDI from the DAC countries only. Thus, they do not capture flows from other developing countries, which may be becoming an increasingly important source of FDI for the LDCs. The UNCTAD/DTCI (Division on Transnational Corporations and Investment) database, which is based mainly on balance-of-payment data, indicates considerably higher FDI inflows to the LDCs in the early 1990s than the DAC figures, e.g. a net inflow estimated at $0.5 billion on average in 1993-1994, excluding flows to Angola and Liberia (see further below).

For LDCs as a group, the net inflow of non-concessional resources continued to show substantial swings from year to year in the early 1990s (varying from a net outflow of $0.3 billion in 1994 to inflows in the order of around $0.8 billion in 1990 and 1993, using OECD/DAC data), with annual variations in the flow into and out of a few countries largely determining the aggregate figures for the group. ODA flows, however, continue to dominate the total flow of resources which fluctuated around a level of $16 to 17 billion throughout the period 1990-1994 (table 4 and chart 1).

Table 4 summarizes available information on long-term resource flows to LDCs and attempts to indicate the scale of the net transfer of resources. (In this table, figures are given for ODA from all sources, not only from DAC countries.) So far in the 1990s, the net transfer of resources, including technical assistance, to the LDCs as a group has remained substantial and relatively stable at a level of $14 to 15 billion annually in current dollar terms. However, this level of resource transfer has largely been maintained because of lower-than-scheduled debt-service payments (through the accumulation of payments arrears on external debt and through debt relief). Scheduled payments that were not met corresponded to as much as one third of the actual resource transfer. If nothing is done to counteract the threat of shrinking ODA, and if debt obligations remain substantial and exigencies to meet them in full not lifted, there is a very real threat that the net transfer of resources to LDCs may sharply diminish over the next few years and that a severe financing crunch for these countries will emerge. In real terms, there has already been a marked decline in ODA and in total flows over the last two years (see annex table 22).

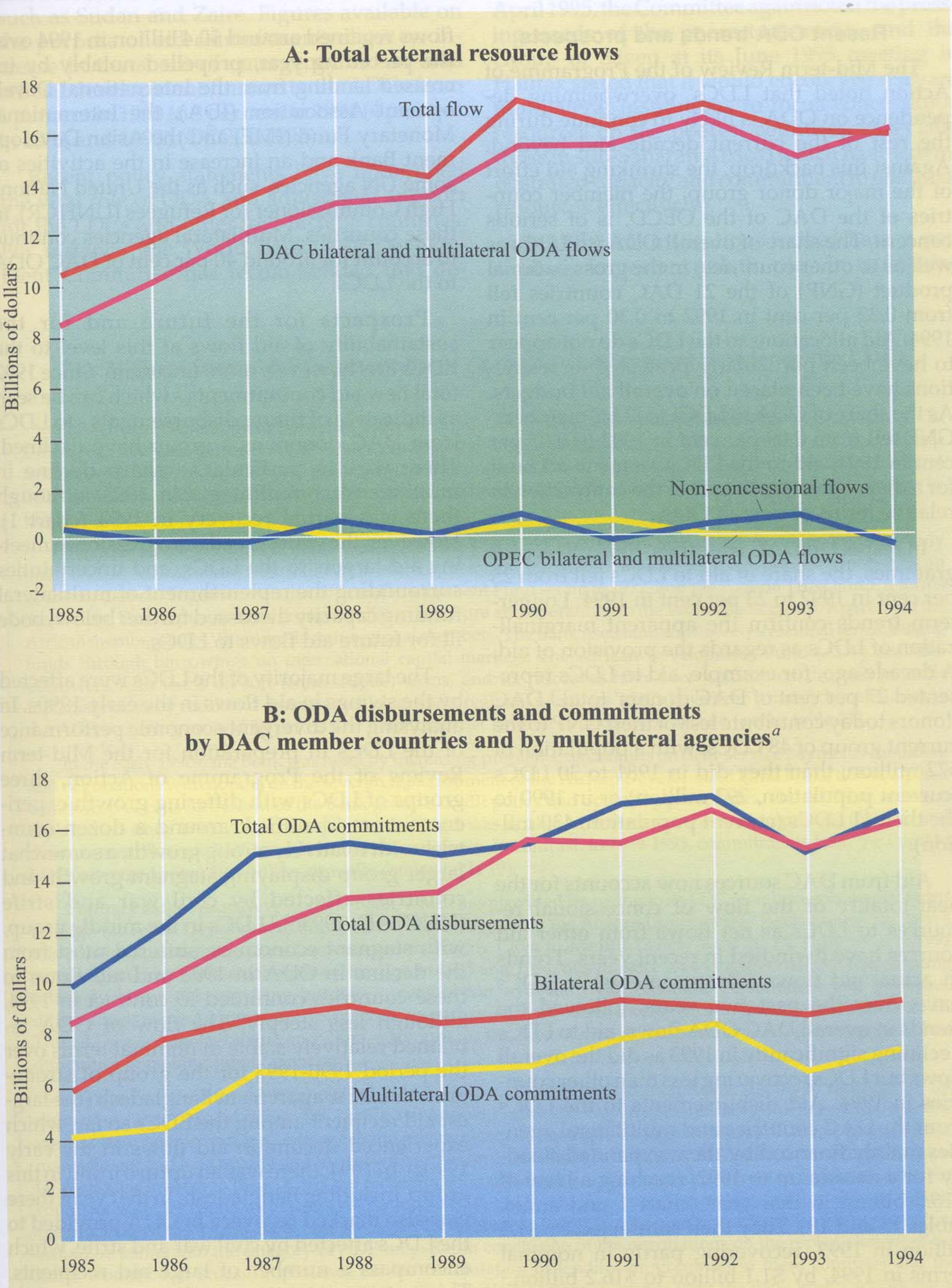
Table 4: Net flow and net transfer of resources to LDCs, 1990-1994

(Billions of dollars)

	1990	*1991*	*1992*	*1993*	*1994*
ODA grants (including technical assistance) (A)	11.7	12.8	12.5	11.9	12.6
Net ODA loans (B)	4.6	3.5	4.1	3.3	3.7
Net ODA (C = A+B)	16.3	16.3	16.6	15.2	16.3
Other official flows, net (D) (excluding IMF)	0.7	-0.1	0.0	0.3	0.2
Private export credits, net[a] (E)	-0.5	-0.4	0.1	-0.6	-1.1
Other private capital flows, net[a] (F)	0.6	0.3	0.3	1.1	0.6
Total private (G = E+F)	0.2	-0.0	0.4	0.5	-0.5
Total net flow of resources (C+D+G)	17.2	16.2	17.0	16.0	16.0
Interest payments on long-term debt	-2.5	-2.1	-1.7	-1.4	(..)
Net purchases under IMF non-concessional facilities	-0.5	-0.3	-0.2	-0.1	-0.0
Net transfer of resources[b]	14.2	13.8	15.1	14.5	(..)
Memo item:					
Accumulation of arrears on debt-service payments	4.6	5.2	4.2	4.7	(..)

Source: UNCTAD estimates based on data from OECD, IMF and the World Bank.
a From OECD/DAC countries.
b Excluding profit remittances on FDI.

Chart 1: The flow of external resources to LDCs, 1985-1994



Source: UNCTAD secretariat, based on OECD data.

a Multilateral agencies financed mainly by DAC member countries.

B. Trends in the volume of official development assistance to LDCs

Recent ODA trends and prospects

The Mid-term Review of the Programme of Action noted that LDCs' overwhelming dependence on ODA is likely to continue during the rest of the current decade and beyond. Against this backdrop, the shrinking aid effort of the major donor group, the member countries of the DAC of the OECD, is of serious concern. The share of overall ODA (to LDCs as well as to other countries) in the gross national product (GNP) of the 21 DAC countries fell from 0.33 per cent in 1992 to 0.30 per cent in 1994. Aid allocations to the LDCs do not appear to have been particularly protected as restrictions have been placed on overall aid budgets. As the share of ODA to LDCs in DAC members' GNP fell from 0.09 per cent in 1992 to 0.07 per cent in 1994, aid to the LDCs seems to account for a disproportionate part of the contraction in relative terms of overall ODA.

In respect to DAC countries' total ODA programmes, the share of aid to LDCs fell from 25 per cent in 1992 to 23 per cent in 1994. Longer-term trends confirm the apparent marginalization of LDCs as regards the provision of aid. A decade ago, for example, aid to LDCs represented 27 per cent of DAC donors' total.[1] DAC donors today contribute less of their GNP to the current group of 48 LDCs, with a population of 572 million, than they did in 1981 to 30 LDCs (current population, 292 million) or in 1990 to the then 41 LDCs (current population, 430 million).

Aid from DAC sources now accounts for the near-totality of the flow of concessional resources to LDCs as net flows from other aid sources have dwindled in recent years. Trends in actual aid flows (disbursements) to LDCs have, over the past two years, followed the trends in overall DAC ODA flows, aid to LDCs declining significantly in 1993 as did the overall flows but LDCs recovering less than other countries in 1994. Aid disbursements to the LDCs from the DAC countries and multilateral agencies mainly financed by them expanded steadily for a decade up to 1992, reaching a level of $16.5 billion in that year (chart 1 and annex tables 15 and 19). They then contracted by $1.5 billion in 1993, recovering partly in nominal terms in 1994, by $1.1 billion to $16.2 billion.[2] Bilateral aid recovered by almost $0.7 billion, with significant increases in dollar terms notably in aid from the United States, but also from Japan and several other countries. Multilateral flows regained around $0.4 billion in 1994 over the preceding year, propelled notably by increased lending from the International Development Association (IDA), the International Monetary Fund (IMF) and the Asian Development Bank and an increase in the activities of some UN agencies, such as the United Nations High Commissioner for Refugees (UNHCR), in these countries. Multilateral agencies continue to account for around 40 per cent of DAC ODA to the LDCs.

Prospects for the future and for the sustainability of aid flows at this level to the LDCs are, however, more uncertain. Since 1992 total new aid commitments - which can be seen as indicative of future disbursements - to LDCs from DAC donors as a group have declined. There was, in particular, a sharp decline in multilateral commitments in 1993, although there was partial recovery in 1994 (chart 1). However, the widespread retrogression in meeting aid targets to the LDCs, and uncertainties surrounding the replenishment of multilateral funding capacity discussed further below, bode ill for future aid flows to LDCs.

The large majority of the LDCs were affected by the swings in aid flows in the early 1990s. In analysing the divergent economic performance of the LDCs in preparation for the Mid-term Review of the Programme of Action, three groups of LDCs with differing growth experiences were identified: around a dozen countries with relatively strong growth; a somewhat larger group displaying stagnant growth; and countries affected by civil war and strife (UNCTAD, 1995c).[3] LDCs in the middle group, with stagnant economies, suffered most from the decline in ODA in 1993 and aid flows to these countries continued to contract in 1994, although less steeply. The flow of ODA remained relatively stable in nominal terms over the period 1990-1993 for the group of strong-growth LDCs, apart from Bangladesh (the largest aid recipient among the LDCs so far, which experienced decline in aid flows in the early 1990s). In 1994, there was an upturn in aid to this group, including Bangladesh. In that year, there was also marked recovery in ODA provided to the LDCs affected by civil war and strife, which encompass a number of large aid recipients. This upturn seems to stem from a response to humanitarian aid needs as in Rwanda, as well as support for countries coming out of civil strife and undertaking political reforms, such as Angola and Haiti. Over the longer term, overall ODA to the

LDCs has been affected by cutbacks in aid to other strife-affected countries such as Sudan and Zaire. Figures available on the purpose of aid commitments show an increase in the share of emergency aid in total official development finance to the LDCs from 1 per cent in 1990 to 3 per cent in 1994 (4 per cent in 1992 and 1993) (OECD, 1996).

Recent policy statements have underlined the vital role of ODA and adjustment support for the LDCs and other low-income countries. For instance, the World Bank/IMF Development Committee has recommended that donors focus concessional assistance on the low-income adjusting countries (World Bank/IMF, 1993). At its meeting in Washington, D.C. in April 1995, the Committee again noted the pressing needs of the poorest countries, and the Group of Seven at its June 1995 meeting in Halifax stated that it would encourage relevant multilateral institutions to focus concessional resources on the poorest countries, especially those in sub-Saharan Africa (which have a demonstrated capacity and commitment to use those resources effectively).

Multilateral institutions indeed have a particularly important role to play in mobilizing support for LDCs' adjustment and develop-

Box 3: The African Development Bank - a major development partner of the LDCs

The African Development Bank has been an important source of external financing for the African LDCs. During the five-year period 1990-1994, net lending by the Bank to LDCs amounted to $2.8 billion. Concessional lending from the Bank's soft window, the African Development Fund, represented 10 per cent of total multilateral ODA received by African LDCs during this period, and was equivalent to over one fourth of total IDA lending to LDCs.

The African Development Bank was established in 1963 and began operations in 1966. Initially, only independent African states were allowed to become members, but in 1982, membership was opened to non-African countries as well. Together with the African Development Fund set up in 1972, and the Nigeria Trust Fund, it forms the African Development Bank group, similar in structure and operations to the World Bank group. Apart from the African member states,[1] there are 24 non-regional members. The Bank itself lends on non-concessional terms, raising funds through borrowings on international capital markets. The African Development Fund (ADF) provides borrowers with loans on soft (concessional) terms, and its resources have been constituted through periodic replenishments by the donor countries which are non-regional members. LDCs have been primary beneficiaries of the ADF, receiving around 80 per cent or more of its net lending over the past decade (annex table 21).

In the early 1990s, the Bank was beset by increasing problems, as defaults on debt-service payments mounted, and negotiations with donors on the seventh replenishment of the African Development Fund broke down, against a backdrop of calls for reform of the Bank group's credit policy and operating procedures. The ADF has not been replenished since 1993. As a consequence, the Fund was unable to make any new loan approvals in 1994, and disbursement flows to LDC members also slowed down. In contrast, in 1989-1993, commitments from the Fund to LDCs averaged some $0.8 billion annually (annex table 19).

Contrary to the Asian Development Bank, which has provided financing to its LDC members only on soft terms through the Asian Development Fund, LDCs' borrowings from the African Development Bank have so far been a mix of loans on non-concessional and concessional terms. Close to one fifth of new loans to LDCs approved in 1992 were still on non-concessional terms (although in 1993 and 1994, this practice was virtually halted). The resulting relatively heavy debt-servicing burden, in conjunction with the weak economic performance and payments difficulties of many African countries in recent years, has led to increased incidence of payments arrears to the Bank. Three LDCs -- Angola, Liberia and Zaire -- account for the bulk of arrears, but a number of others also have had difficulties in making timely payments.

A new President for the Bank was elected in August 1995. Efforts to recapitalize the Bank, reconstitute the resources of the ADF and reform the Bank's management are under way. Its operational guidelines with regard to areas of intervention and, e.g., support to the private sector, are being re-examined. Measures to improve financial management and loan quality and to deal with arrears are also under review, as is the Bank's internal organization. Of particular interest to the LDCs is the reclassification of borrowers with regard to access of resources, whereby countries with per capita income not exceeding $543 would be eligible for soft-term ADF lending only (similar to the practices of the World Bank and the Asian Development Bank). Thirty-nine of the Bank's member countries would be falling into the category of ADF-only. Rapid conclusion of the negotiations on the replenishment of the Fund would be of crucial importance for the continuation of lending programmes in these countries and the development of new projects, and in maintaining a significant flow of finance from the Bank group and its status as a major development partner of the African LDCs.

1 In 1995, South Africa decided to join the Bank as its 53rd regional member state.

ment efforts. While bilateral ODA programmes have also been reduced in a number of DAC countries, the multilateral aid effort came under particular pressure in 1995. These pressures were already evident in the difficulties in agreeing on the 8th European Development Fund (EDF), a major source of assistance for those LDCs which are party to the Lomé Convention.[4] In June 1995, European Union member States finally reached agreement on making available 13.3 billion European currency units (some $17.2 billion) for the second half of the decade, which should broadly maintain the level of EDF resources in real terms. However, a similar outcome was far from guaranteed regarding the 11th replenishment of IDA (IDA-XI), covering the period mid-1996 to mid-1999. Meanwhile, uncertainties also continued with respect to the replenishment of the concessional funds of the regional development banks, which are likewise important financing sources for the LDCs (box 3), and grant-based multilateral programmes also met the threat of shrinking resources. Over the next few years, the question of financing the IMF Enhanced Structural Adjustment Facility (ESAF) until a self-sustaining ESAF becomes available early in the next century likewise needs to be settled.

What are the reasons for the seeming withdrawal of commitment to assisting the poorest countries, as most evident in the shrinking share of aid to LDCs in the GNP of a number of donor countries and the threats of cutback in multilateral funding? A number of factors can be cited, among them budgetary pressures, competing claims on donor countries' attention and resources, disappointment with the results of decades of development cooperation which has been termed "donor fatigue", and changes in perception of strategic and economic interest. Moreover, precisely because conditions in the LDCs are the most difficult and management and institutional capacities in these countries are generally weak, many LDCs also have difficulties in meeting the requirements for the provision of aid that donors now set with regard to effective use of aid and policy reform in various areas. This may well weaken their position in the competition for aid resources. To these more general absorptive capacity constraints are added governance-related problems and civil strife in a number of LDCs (some of which are potentially large aid recipients), severely restricting the scope for implementing aid programmes.

The above points to two major issues facing the international donor community as ODA resources are becoming increasingly scarce in relation to needs. One is prioritizing LDCs in donors' aid programmes more clearly. This also implies seriously addressing absorptive capacity constraints in these countries. The second issue, which is an element of the former but which is important enough to warrant separate and immediate attention, is that of sustaining multilateral aid flows to the LDCs. The latter requires urgent action to ensure the resource base and significant replenishment of the concessional windows of the international financial institutions and of multilateral funds and programmes providing grant assistance to the LDCs.

Resource mobilization for individual LDCs

Consultative and aid groups and round-table and similar meetings continue to play an important role in the mobilization of external resources for LDCs at the individual country level as well as in aid coordination. Around 70 such groups and meetings (excluding sectoral and other follow-up events) were organized up to the end of 1995 following the adoption of the Programme of Action. As regards the two countries added to the list at the end of 1994, a consultative group for Eritrea was constituted in December 1994, while a round-table meeting was held for Angola in September 1995 (table 5). Some of the most recent meetings have been remarkably successful in terms of commitments (e.g. almost $800 million was promised for the rehabilitation and development of Angola). The increasing involvement of LDC Governments in the preparation of meetings and the more active role assumed by them in the country-review process is also an important recent development. Commitments still need to be translated into actual aid flows, and here flexibility in aid conditions and practices and removal of absorptive capacity constraints are important to permit rapid disbursement and full benefits from these exercises. Moreover, the review process has not yet been established on a regular basis in all LDCs. One fourth of the LDCs did not arrange any meetings of this kind during 1990-1995. A number of them were countries in civil war or where aid programmes were suspended due to governance-related problems. Others, for other reasons, were not able to put together the internationally agreed structural adjustment programmes which have virtually become a precondition for donors agreeing to the convening of consultative and aid groups and round-table meetings.

Table 5: Consultative and aid groups and round-table meetings, 1990-1995[a]

	1990	*1991*	*1992*	*1993*	*1994*	*1995*
Consultative and aid group arrangements						
Bangladesh	♦	♦	♦	♦	♦	♦
Eritrea					♦	
Ethiopia			♦		♦	
Guinea	♦					
Haiti	♦	♦	♦[b]		♦[b]	♦
Malawi	♦		♦	♦	♦	♦
Mauritania					♦	
Mozambique	♦	♦	♦	♦		♦
Nepal	♦		♦			
Sierra Leone					♦	
Somalia	♦					
Uganda		♦	♦	♦	♦	♦
United Republic of Tanzania		♦	♦	♦		♦
Zambia	♦	♦	♦	♦	♦	♦
Round table and other arrangements						
Angola						♦
Benin			♦			
Bhutan			♦			♦
Burkina Faso		♦		♦		♦
Burundi			♦			
Cambodia[c]			♦	♦	♦	♦
Cape Verde			♦			♦
Central African Republic		♦			♦	
Chad	♦					
Comoros		♦				
Gambia	♦		♦		♦	
Guinea-Bissau					♦	
Lao People's Democratic Republic			♦		♦	
Lesotho						♦
Maldives		♦			♦	
Mali					♦	
Rwanda			♦			♦
Samoa	♦					
Sao Tome and Principe			♦			
Tuvalu	♦	♦				
Yemen			♦			

Source: Information from UNDP and the World Bank.

Note: The list of consultative and aid groups and round-table meetings held prior to 1990 can be found in *The Least Developed Countries 1995 Report,* table 22.

a No meetings during 1990-1995 for Afghanistan, Djibouti, Equatorial Guinea, Kiribati, Liberia, Madagascar, Myanmar, Niger, Solomon Islands, Sudan, Vanuatu and Zaire.

b Caribbean Group for Cooperation in Economic Development.

c Ministerial Conference on Rehabilitation and Reconstruction of Cambodia, co-chaired by UNDP (1992) and the International Committee on the Reconstruction of Cambodia (since 1993).

C. Limited progress in meeting ODA targets for LDCs

In one of the key provisions in the Programme of Action, the international community, particularly the developed countries, committed itself to a significant and substantial increase in the aggregate level of external support to LDCs. A set of alternative aid targets and commitments were adopted to encourage donor countries to increase their efforts and improve their aid performance, so that aid flows commensurate with the required increase in support to LDCs would be achieved. However, instead of progress towards these targets, the early 1990s saw retrogression in meeting them on the part of many donor countries. In 1990, DAC donors collectively contributed 0.09 per cent of their GNP as ODA to the current group of 48 LDCs. After varying between 0.08 and 0.09 per cent in 1991-1993, this share fell to only 0.07 per cent in 1994.

This retrogression has taken place as the number of LDCs has increased from 41 to 48 since the Programme of Action was adopted in 1990. It was already estimated at that time that the volume of aid resulting from the implementation of the menu of ODA targets and commitments in the Programme would not be sufficient to fully meet the external resource requirements of the then 41 LDCs. In view of subsequent developments, and the increase in the number of LDCs, the adequacy of the targets needs to be reassessed, and the question of their adjustment remains pending on the international agenda.

In dollar terms, the United States in 1994 maintained its position as the largest source of ODA to LDCs, followed by Japan, Germany and France.[5] Annual contributions to aid to LDCs have, in recent years, been well above $2 billion for the United States and Japan. These two donors together currently provide around one third of total DAC aid to the LDCs. The countries members of the European Union provide somewhat over 50 per cent.

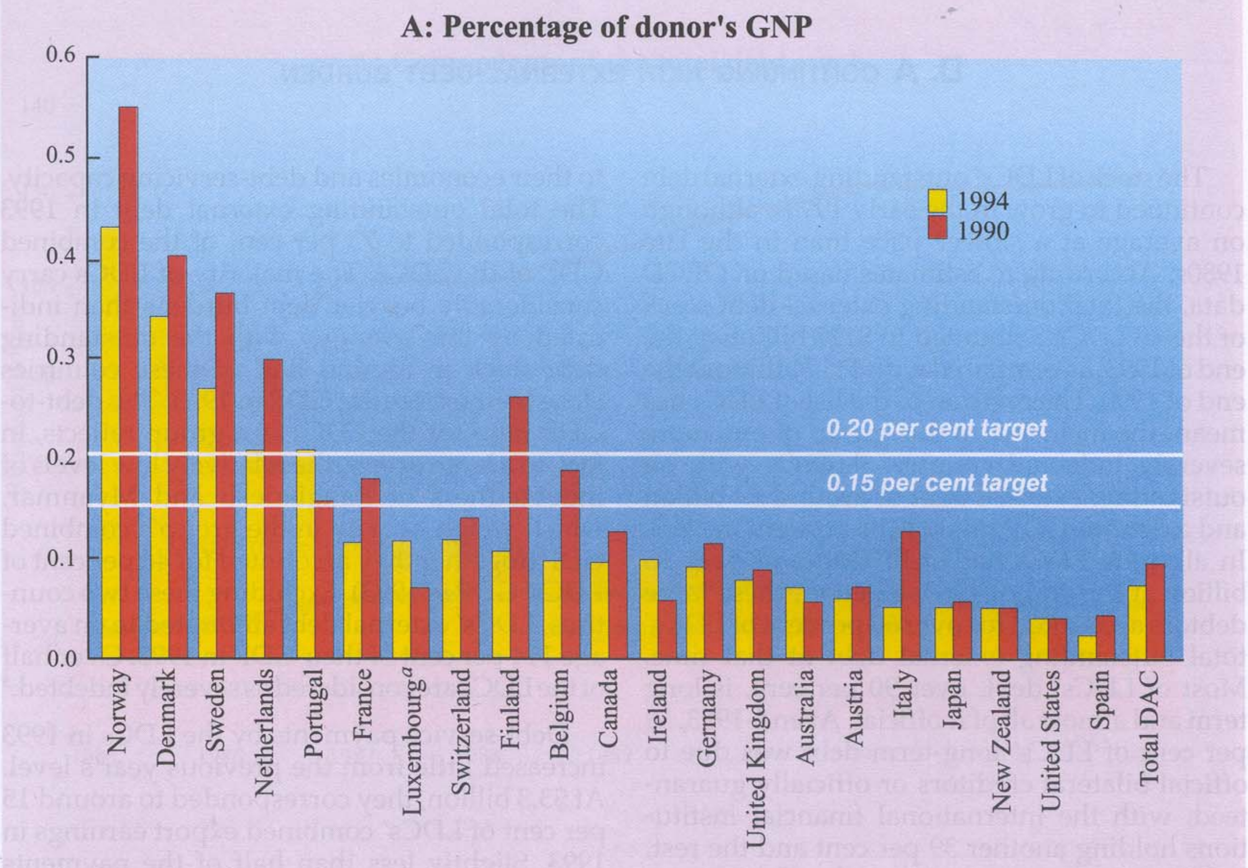
In 1994, five DAC countries continued to meet the objective of providing more than 0.20 per cent of their GNP as ODA to LDCs: Norway, Denmark, Sweden, the Netherlands and Portugal. Norway with 0.43 per cent continued to be the top performer. In 13 of the 21 DAC countries, the ODA contribution to LDCs (measured as bilateral aid plus imputed contributions through multilateral institutions) was lower in dollar terms in 1994 than in 1990. In Belgium, Finland and France, contributions declined so that they no longer met the 0.15 per cent target, which they had all surpassed in 1990 (chart 2 and annex table 18).

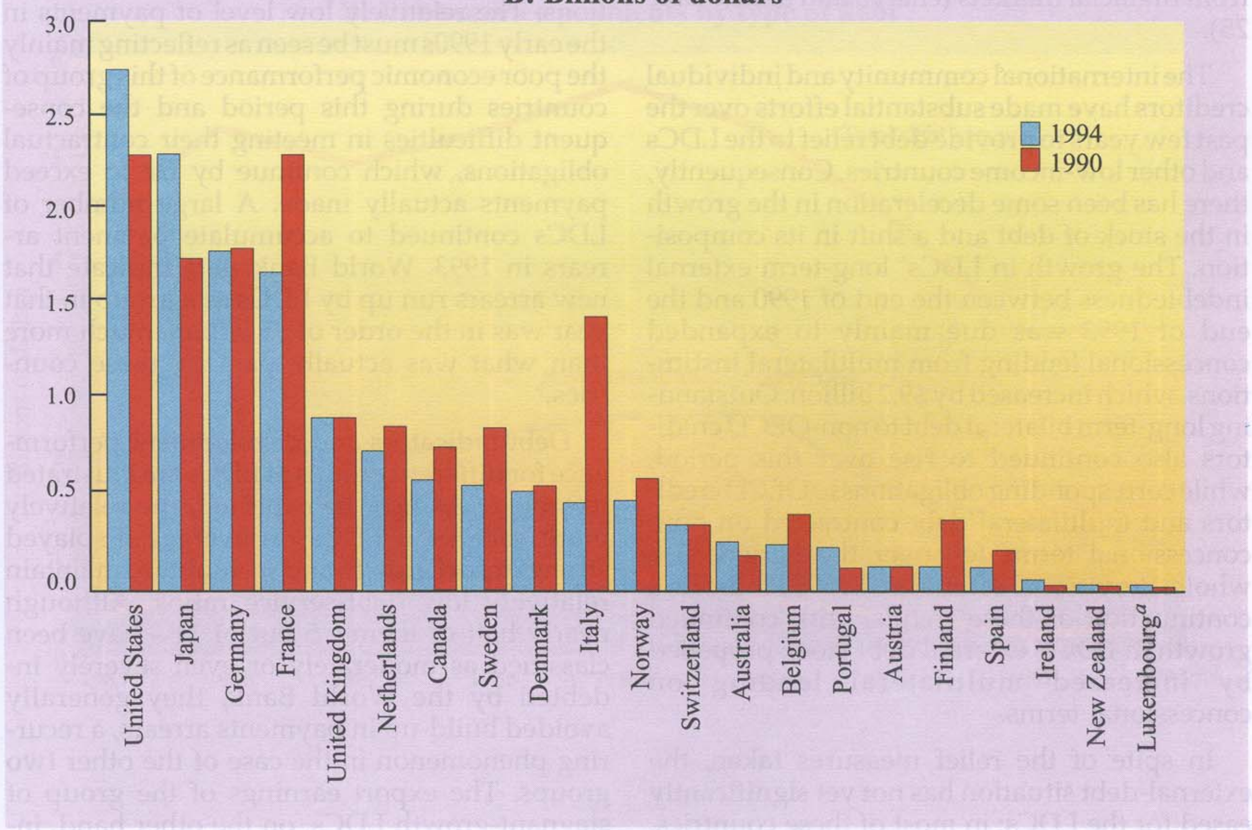
The set of alternative aid targets and commitments, i.e. the "menu" adopted in the Programme of Action, aimed to take into account the aid policies and performance *vis-à-vis* LDCs of different donors, in order to encourage them to strengthen their efforts. The first three of the options on the menu incorporated the objectives of making progress in terms of the targets of 0.20 per cent or 0.15 per cent of GNP as aid to LDCs. However, the performance of most donors concerned by these targets has been disappointing. Only four DAC countries improved their aid performance *vis-à-vis* LDCs in terms of GNP share between 1990 and 1994: Australia, Ireland, Luxembourg[6] and Portugal. In particular, the GNP shares of many important donors contracted further in 1994. The share of aid to LDCs in the combined GNP of the countries members of the European Union fell to 0.10 per cent in 1994, as compared with 0.12 per cent in 1993.[7]

The fourth option in the menu of aid targets and commitments called for donor countries to "exercise their best efforts individually to increase their ODA to LDCs". The two largest aid donors to LDCs, the United States and Japan, have so far both made progress in terms of this commitment: Japan steadily increasing its aid to LDCs in dollar terms since 1990 and the United States also improving its performance in the last three years in comparison with 1990. The GNP shares of Japan and the United States (at 0.05 per cent and 0.04 per cent, respectively, in 1994) are among the lowest of the DAC countries, but they have maintained these shares throughout 1990-1994. Their efforts will continue to be crucial in maintaining aid flows to the LDCs.

The High-level Intergovernmental Meeting on the Mid-term Review of the Programme of Action agreed that donors need to expeditiously implement the agreed menu of aid targets and/or commitments as set out in paragraph 23 of the Programme and fulfil their commitments to provide a significant and substantial increase in the aggregate level of external support to LDCs, keeping in mind the increased needs of these countries, as well as the requirements of the new countries included in the list of LDCs following the Paris Conference. Many donors indeed have a major effort to make with respect to these targets and commitments in order to make

Chart 2: ODA to LDCs from DAC member countries, 1990 and 1994





Source: UNCTAD secretariat, based on OECD data.

a Data for Luxembourg are for the years 1990 and 1993.

up for the ground lost in the early 1990s. In this respect, the Mid-term Review indicated the actions needed to improve performance in the latter half of the decade (see annex I).

D. A continuing high external-debt burden

The stock of LDCs' outstanding external debt continued to grow in the early 1990s, although on average at a slower pace than in the late 1980s. According to estimates based on OECD data, the total outstanding external debt stock of the 48 LDCs amounted to $127 billion at the end of 1993, as compared with $117 billion at the end of 1990. The revision of the list of LDCs has meant the inclusion in this group of one more severely indebted country, Angola, with an outstanding external debt of around $9 billion and a debt-to-GDP ratio of 186 per cent in 1993. In all, nine LDCs had debt stocks of over $5 billion at the end of 1993; together, these large debtors accounted for over 60 per cent of LDCs' total outstanding external debt at that time. Most of LDCs' debt, over 90 per cent, is long term and almost all of it official. At end-1993, 59 per cent of LDCs' long-term debt was due to official bilateral creditors or officially guaranteed, with the international financial institutions holding another 39 per cent and the rest, some 2 per cent, constituted by borrowings from financial markets (chart 3 and annex table 25).

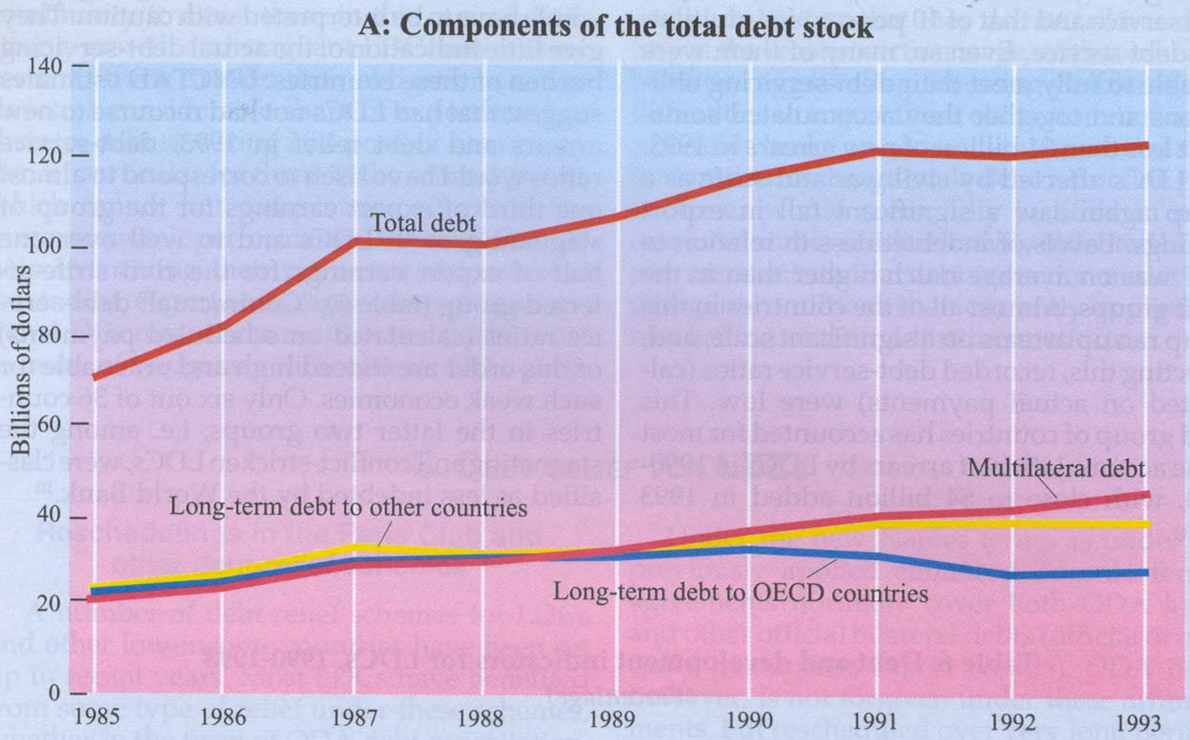
The international community and individual creditors have made substantial efforts over the past few years to provide debt relief to the LDCs and other low-income countries. Consequently, there has been some deceleration in the growth in the stock of debt and a shift in its composition. The growth in LDCs' long-term external indebtedness between the end of 1990 and the end of 1993 was due mainly to expanded concessional lending from multilateral institutions, which increased by $9.2 billion. Outstanding long-term bilateral debt to non-OECD creditors also continued to rise over this period, while corresponding obligations to OECD creditors and multilateral debt contracted on non-concessional terms fell over the period as a whole. Provisional estimates for 1994 indicate a continuation of these trends, with continued growth in LDCs' external debt stock propelled by increased multilateral lending on concessional terms.

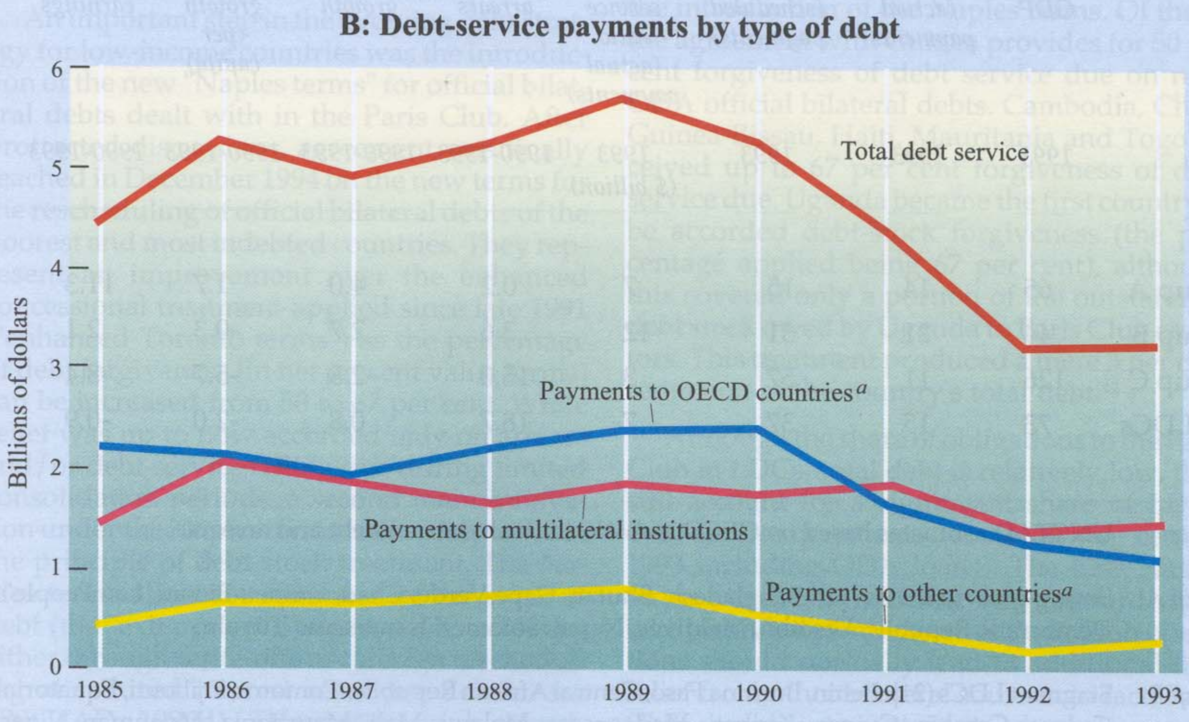
In spite of the relief measures taken, the external-debt situation has not yet significantly eased for the LDCs; in most of these countries, the debt burden remains enormous in relation to their economies and debt-servicing capacity. The total outstanding external debt in 1993 corresponded to 73 per cent of the combined GDP of the LDCs. The majority of LDCs carry considerably heavier debt burdens than indicated by this average, with the outstanding debt stock in around half of these countries close to or exceeding GDP in 1993. The debt-to-GDP ratio for the LDCs as a group reflects, in fact, to a large extent, the relatively low levels of indebtedness of Bangladesh and Myanmar, which weigh heavily in the group's combined GDP (together they accounted for 46 per cent of LDCs' GDP in 1993). Excluding these two countries, LDCs' external debt amounted to on average 114 per cent of their GDP in 1993. Over half of the LDCs are considered as severely indebted.[8]

Debt-service payments by the LDCs in 1993 increased little from the previous year's level. At $3.3 billion, they corresponded to around 15 per cent of LDCs' combined export earnings in 1993. Slightly less than half of the payments were made on account of multilateral obligations. The relatively low level of payments in the early 1990s must be seen as reflecting mainly the poor economic performance of this group of countries during this period and the consequent difficulties in meeting their contractual obligations, which continue by far to exceed payments actually made. A large number of LDCs continued to accumulate payment arrears in 1993. World Bank data indicate that new arrears run up by LDCs as a group in that year was in the order of $5 billion, much more than what was actually paid by these countries.[9]

Debt indicators and development performance for different groups of LDCs are illustrated in table 6. As may be expected, the relatively more successful LDCs on average displayed strong export growth and were able to maintain relatively low debt-service ratios. Although nearly half of them - 5 out of 11 - have been classified as moderately or even severely indebted by the World Bank, they generally avoided build-up in payments arrears, a recurring phenomenon in the case of the other two groups. The export earnings of the group of stagnant-growth LDCs, on the other hand, increased only modestly in the early 1990s. Although the debt-to-GDP ratio of these countries was lower than for the first group, debt-service

Chart 3: External debt and debt-service payments of LDCs, 1985-1993





Source: UNCTAD secretariat, based on OECD data.
a Payments on long-term debt only.

ratios in 1993 were significantly higher - surpassing the benchmark of 20 per cent for total debt service and that of 10 per cent for multilateral debt service. Even so, many of them were not able to fully meet their debt-servicing obligations and together they accumulated somewhat less than $1 billion of new arrears in 1993. The LDCs affected by civil war and strife as a group again saw a significant fall in export earnings. Levels of indebtedness in relation to GDP was on average much higher than in the other groups. Almost all of the countries in this group ran up arrears on a significant scale, and, reflecting this, recorded debt-service ratios (calculated on actual payments) were low. This third group of countries has accounted for most of the accumulation of arrears by LDCs in 1990-1993, with close to $4 billion added in 1993 alone.

Because of the non-servicing of a large part of their contractual obligations, recorded debt-service ratios for stagnant-growth and civil strife-affected LDCs and for the group as a whole have to be interpreted with caution. They give little indication of the actual debt-servicing burden of these countries. UNCTAD estimates suggest that had LDCs not had recourse to new arrears and debt relief in 1993, debt-service ratios would have risen to correspond to almost one third of export earnings for the group of stagnant-growth LDCs and to well over one half of export earnings for the civil strife-affected group (table 6). "Contractual" debt-service ratios (calculated on scheduled payments) of this order are indeed high and untenable for such weak economies. Only six out of 36 countries in the latter two groups, i.e. among the stagnating and conflict-stricken LDCs, were classified as less indebted by the World Bank.[10]

The foregoing comments serve to illustrate the actual difficulties of LDCs in meeting their debt-servicing obligations and indicate the actions needed to be taken by the international

Table 6: Debt and development indicators for LDCs, 1990-1993

(Percentage)

Country groups	*Ratio of total debt to GDP*	*Debt-service ratio (actual payments)*	*Debt-service ratio (scheduled payments)*	*Multi-lateral debt service ratio (actual payments)*	*Accumu-lation of arrears*	*Real annual GDP growth*	*Real annual GDP growth (per capita)*	*Growth in export earnings*
	1993	*1993*	*1993*	*1993*	*1990-1993 ($ billion)*	*1990-1993*	*1990-1993*	*1990-1993*
Group A	65	14	15	7	0.2	4.0	1.7	11.3
Group B	44	21	31	12	3.6	2.7	-0.3	2.1
Group C	126	11	57	3	15.0	-2.8	-5.7	-8.4
All LDCs	73	15	37	7	18.7	0.8	-2.0	-0.9

Source: UNCTAD estimates based on OECD and World Bank data on debt and arrears.

Note:

Group A Strong-growth LDCs (11): Bangladesh, Bhutan, Cape Verde, Chad, Guinea-Bissau, Lao People's Democratic Republic, Lesotho, Maldives, Nepal, Solomon Islands and Tuvalu;

Group B Stagnant LDCs (21): Benin, Burkina Faso, Central African Republic, Comoros, Djibouti, Equatorial Guinea, Gambia, Guinea, Kiribati, Madagascar, Malawi, Mali, Mauritania, Myanmar, Niger, Samoa, Sao Tome and Principe, Uganda, United Republic of Tanzania, Vanuatu and Zambia;

Group C Civil strife/war-affected LDCs (16): Afghanistan, Angola, Burundi, Cambodia, Eritrea, Ethiopia, Haiti, Liberia, Mozambique, Rwanda, Sierra Leone, Somalia, Sudan, Togo, Yemen and Zaire.

community to assist them in this regard. Both strong-growth and stagnant LDCs are making serious efforts to meet their obligations and to devote a considerable share of export receipts thereto; debt servicing still poses a heavy burden in particular for those in the second group, which cannot but compromise efforts to improve economic performance. These LDCs need help in meeting their payments at least until expanding exports can carry more of this burden. LDCs may of course also need debt relief because of budgetary difficulties.[11] Debt problems appear most severe in the third group, which also carries massive arrears. Here, the international community must stand ready to act quickly to help countries coming out of civil war and strife, so that they do not fall in a debt trap at the reconstruction stage, with too-heavy liabilities aggravating financing problems and difficulties to acquit these obligations acting as a possible brake on access to international support measures. Large-scale debt-reduction programmes would seem fully justified in such cases. A number of other heavily indebted LDCs also merit substantial debt reduction under less stringent conditions than currently applied, in recognition of their adjustment efforts.

E. Debt relief for LDCs

Reschedulings in the Paris Club and other debt-relief schemes

A number of debt-relief schemes for LDCs and other low-income countries have been set up in recent years. Most LDCs have benefited from some type of relief under these schemes, whether in the form of ODA debt cancellation, reschedulings of official bilateral debts in the Paris Club, commercial debt buy-backs or multilateral debt arrangements (table 7).

An important step in the evolving debt strategy for low-income countries was the introduction of the new "Naples terms" for official bilateral debts dealt with in the Paris Club. After protracted discussions, agreement was finally reached in December 1994 on the new terms for the rescheduling of official bilateral debts of the poorest and most indebted countries. They represent an improvement over the enhanced concessional treatment applied since late 1991 ("enhanced Toronto terms") as the percentage of debt forgiveness (in net present value terms) can be increased from 50 to 67 per cent. While relief was up to now accorded only on arrears and/or debt service falling due during limited consolidation periods, a second main innovation under the Naples terms is the acceptance of the principle of debt-stock treatment. The Naples terms allow for reduction of the stock of debt (the "exit option"), which can be achieved either through write-offs or through rescheduling at reduced interest rates (for details, see UNCTAD, 1995d). This option is, however, likely to be implemented only for a small number of countries with a sufficient track record of adjustment, the expectation being that having completed their exit programme, they would no longer return to the Paris Club.

Under the new Naples terms as under the previously applied enhanced Toronto terms, agreements normally cover both ODA loans and other official bilateral debts (official or officially guaranteed export credits). ODA debt, however, is not forgiven under these arrangements, but rescheduled over very long periods (30 to 40 years).

In 1995, eight LDCs had their official bilateral debts rescheduled in the Paris Club after the introduction of the Naples terms. Of these, the agreement with Guinea provides for 50 per cent forgiveness of debt service due on non-ODA official bilateral debts. Cambodia, Chad, Guinea-Bissau, Haiti, Mauritania and Togo received up to 67 per cent forgiveness of debt service due. Uganda became the first country to be accorded debt-stock forgiveness (the percentage applied being 67 per cent), although this covered only a portion of the outstanding debt stock owed by Uganda to Paris Club creditors. This treatment produced a mere 3 per cent reduction of the country's total debt.[12]

Although the share of obligations to the Paris Club in LDCs' total debt is relatively low, they still account for a significant share of LDCs' debt-service payments (some 30 per cent in 1993 including ODA loans). The new Naples terms are thus a welcome step forward. They take on added significance as Paris Club operations should normally lead to additional debt relief from other bilateral sources. In fact, Paris Club agreements contain standard clauses under which the debtor country agrees to seek relief from other creditors on terms comparable with those obtained in the rescheduling.

The UNCTAD secretariat has undertaken a simulation of the impact of the Naples terms option of 67 per cent debt-stock reduction of debts due to Paris Club creditors on the projected debt-service ratios of a sample of potential beneficiary countries, of which 22 are LDCs. (Repayment obligations to the IMF, which are substantial for some LDCs, were not included in the simulations. Moreover, the eventual impact on other bilateral debts was not taken into account.) The results of the simulation show that for half of the LDCs included in the sample, such debt-stock reduction would significantly lower debt-service ratios, helping, in four of these countries, to bring these ratios down to manageable levels (i.e. below a benchmark ratio of 20 per cent of export earnings; however, how arrears would be dealt with would have important implications for the levels of debt service.) In the other half of the LDCs included in the sample, the impact of debt-stock reduction under the Naples terms would be relatively smaller. For some of the countries in the first group, debt-service obligations on post-cut-off date debt would remain important. The simulation indicates that because of remaining debt-service obligations to other bilateral creditors and multilateral institutions, even full implementation of the Naples terms alone would not be sufficient to bring down debt-service ratios to manageable levels in many LDCs (UNCTAD, 1995d).

It can be concluded that unless the Naples terms are applied to a sizeable part of total outstanding debt, and unless debt-stock reduction is extended to a much larger number of countries than initially, and other bilateral creditors rapidly follow suit, their impact on LDCs' debt overhang may remain limited. It can also be observed that Paris Club operations are growing increasingly complex, and associated transaction costs risk becoming very high. Working out specific bilateral agreements with each creditor country to implement the general guidelines agreed in Paris, and similar arrangements with other creditor countries, can be a long and laborious process. Moreover, these operations need to be complemented not only by equivalent measures by other official creditors, but also by action on other types of debt, e.g. support for reduction of debt owed to commercial banks and measures to alleviate multilateral debt burdens.

Apart from the major new Naples initiative, other debt-relief schemes set up earlier continue to be applied and some new measures have been announced. At the World Summit for Social Development, held in Copenhagen in March 1995, Denmark announced the implementation of additional measures to forgive outstanding development loans (a number of LDCs have already benefited from ODA debt relief by Denmark on a case-by-case basis.) Moreover, Austria pledged to write off a substantial amount of debt for the poorest and most indebted countries. In addition to the five buy-backs of commercial debt for LDCs undertaken earlier under the IDA Debt Reduction Facility (DRF), Sierra Leone completed the first phase of a new buy-back in the first half of 1995; $148 million of debt was extinguished at a cost of $22 million. Similar operations were under preparation for four more LDCs (Ethiopia, Guinea, Mauritania and the United Republic of Tanzania). Under the "fifth dimension" programme of IDA, six LDCs in FY 1995 received a total of $22.6 million in supplemental allocations (provided to help offset interest due on outstanding debt contracted at IBRD terms). Bilateral donors have contributed to the financing of DRF debt-reduction operations as well as provided additional assistance under the "fifth dimension".

Under the IMF approach to deal with member countries in arrears to the institution, rights accumulation programmes (RAPs) have been designed to help such countries clear their arrears and to allow resumed IMF lending to them. Zambia successfully completed its RAP programme in December 1995 and concluded new financing arrangements with the Fund under the Structural Adjustment Facility (SAF) and ESAF, totalling some $1.3 billion.[13]

Other recent policy developments

The international community continues to seek solutions to the plight of the poor debt-distressed countries. Thus, debt issues figured prominently on the agenda of the World Summit for Social Development. In the Declaration adopted by the Summit, the international community committed itself to finding "effective, development-oriented and durable solutions" to the external debt problems of Africa and the LDCs, calling specifically for immediate implementation of the terms of debt forgiveness agreed on in the Paris Club in December 1994, and also inviting the international financial institutions to examine innovative approaches to assist low-income countries with a high proportion of multilateral debt with a view to alleviating their debt burdens. Moreover, a commitment was made to develop techniques of debt conversion applied to social development programmes and projects.

The issue of multilateral debt has recently come increasingly to the fore. So far, relatively little assistance has been available to help debt-distressed countries in meeting multilateral debt-service obligations (i.e. help in meeting debt-service payments under the "fifth dimension",

Table 7: LDCs - Debt indicators and debt-relief measures

Country / group[a]	*Outstanding debt end-1993 ($ Million)*	*Ratio of total debt to GDP 1993 (%)*	*Ratio (to 1993 total exports)*[b] *of: Total debt service (%)*	*Multi-lateral debt service (%)*	*Increase in arrears in 1993*[c]	*ODA debt cancellations in 1990-1994*[d]	*Paris Club agreements under enhanced Toronto or Naples terms*	*"Fifth dimension" support 1990-1995*	*SPA eligible (1995)*	*SAF/ ESAF support (1990-1995)*
Debt to GDP ratio over 100%										
Afghanistan**	9579	104	6	2	..					
Angola**	8942	186	5	0	x					
Burundi**	1091	115	41	28		x			x	x
Equatorial Guinea**	316	202	3	2	x	x	1992		x	x
Gambia*	438	113	11	6		x			x	x
Guinea-Bissau**	640	266	25	19	x	x	1995		x	x
Lao People's Democratic Republic**	2005	150	8	2		x				x
Lesotho	761	103	6	2		x				x
Liberia**	1746	128	9	3	x	x				
Madagascar**	3656	108	23	13	x	x		x	x	x
Mauritania**	2041	215	31	23		x	1993, 1995	x	x	x
Mozambique**	4698	333	22	7	x	x	1993		x	x
Samoa*	183	122	11	6						
Sao Tome and Principe**	232	592	17	17	x				x	x
Sierra Leone **	831	114	15	7	x	x	1992, 1994	x	x	x
Somalia**	1985	167	10	0	x	x				
Sudan**	10708	113	31	5	x	x				
United Republic of Tanzania**	5548	234	24	12	x	x	1992	x	x	x
Vanuatu	237	131	28	1		x				
Yemen**	8736	205	9	6	x	x				
Zaire**	9899	117	15	2	x	x				
Zambia**	5275	146	37	26		x	1992	x	x	x
Subtotal	**79547**	**144**	**15**	**7**						
Debt to GDP ratio 50-100%										
Bangladesh*	14203	59	18	9		x		x		x
Benin*	1377	65	8	5		x	1991, 1993		x	x
Cambodia	1918	100	9	8			1995			x
Central African Republic**	823	67	7	5	x	x	1994		x	
Chad*	738	62	7	6		x	1995		x	x
Comoros*	190	76	8	6	x	x			x	x
Djibouti	279	60	3	1		x				
Ethiopia**	4178	80	17	8	x	x	1992	x	x	x
Guinea**	2675	84	11	4	x	x	1992, 1995	x	x	x
Kiribati	21	60	4	4						
Malawi*	1866	92	21	13		x		x	x	x
Maldives	162	71	4	1						
Mali**	2306	87	7	5	x	x	1992		x	x
Nepal*	2091	56	9	4		x				x
Niger**	1498	67	40	22	x	x	1994		x	x
Rwanda**	865	58	8	5	x	x			x	x
Solomon Islands	196	80	32	1						
Togo*	1197	89	14	8	x	x	1992, 1995	x	x	x
Tuvalu	6	52		..	..					
Uganda**	2901	88	86	27		x	1992, 1995	x	x	x
Subtotal	**39490**	**69**	**17**	**8**						
Debt to GDP ratio below 50%										
Bhutan	92	40	11	1						
Burkina Faso	1228	44	11	8		x	1993		x	x
Cape Verde	145	47	10	6	x	x				
Eritrea	..	..	..	..	..	..			x	
Haiti	693	48	2	0	x	x	1995			
Myanmar**	5497	10	10	4	x	x				
Subtotal	**7655**	**13**	**9**	**4**						
Total	**126692**	**73**	**15**	**7**						

Source: UNCTAD secretariat, based mainly on information from OECD and the World Bank.

a An asterisk indicates a country classified as moderately indebted by the World Bank in *World Debt Tables, 1994-95*; a double asterisk one that is classified as severely indebted.

b Exports of goods and services.

c An "x" indicates a country where payments arrears as recorded in *World Debt Tables, 1994-95* increased in 1993, and arrears amounted to 5 per cent or over of total outstanding debt at end-1993.

d As reported by donors in response to UNCTAD questionnaires on the implementation of the Programme of Action for the LDCs for the 1990s.

IMF rights accumulation programmes and support groups for the clearance of arrears (see also UNCTAD, 1995b)). Subsequent to the World Summit for Social Development, this issue was taken up at the meeting of the Development Committee held in Washington, D.C. in April 1995. However, the Committee at this occasion merely noted that some of the poorest and most heavily indebted countries have a heavy burden of debt owed to multilateral institutions, inviting the Executive Boards of the World Bank and the IMF to continue their review of this subject.

The Group of Seven, at its summit meeting in Halifax in June 1995, urged the full and constructive implementation of the Naples terms. It also recognized that some of the poorest countries have substantial multilateral debt burdens. In this connection, participating heads of States and governments stated that they would encourage the Bretton Woods institutions to develop a comprehensive approach to assist countries with multilateral debt problems through the flexible implementation of existing instruments and new mechanisms where necessary, along with the better use of all existing World Bank and IMF resources and the adoption of appropriate measures in the multilateral development banks to advance this objective. The subject was taken up again by the Development Committee in October 1995. While participants considered that current instruments should be sufficient to bring debt and debt service down to manageable levels for the majority of heavily indebted poor countries, they did recognize that "for a small group of countries, however, this may still leave an unsustainable debt situation, a problem for which appropriate approaches need to be further explored" (World Bank/IMF, 1995). The World Bank and the IMF were requested to continue their work on this issue, including detailed country-specific analysis of debt sustainability, and to report with proposals to the Committee at its next meeting in April 1996.

Drawing on the progressive evolution in the international community's thinking about low-income countries' debt problems and the solutions required for various components of this debt, it was possible at the Mid-term Review of the Implementation of the Programme of Action to agree on the elements of a debt strategy for the LDCs (see annex I). However, the effective implementation of this strategy will depend on the action that will be taken by LDCs' creditors in the relevant forums as well as bilaterally.

Mechanisms have already been put in place to deal with ODA debt, other official bilateral debts to Paris Club creditors (Naples terms) and commercial debts (the DRF).[14] Some arrangements have also been made to help countries with payments and clearance of arrears on multilateral debt, as indicated above. However, most of these schemes are available only to debt-distressed LDCs undertaking IMF-supported adjustment programmes. And new mechanisms remain to be developed, notably to deal with excessive multilateral debt burdens and with liabilities to non-Paris Club creditors. A high share of outstanding debt to the latter are characteristic of a number of LDCs, and a comprehensive debt strategy for LDCs would also need to include mechanisms for dealing with this part of their debt, as suggested at the Mid-term Review of the Programme of Action. How to help conflict-stricken countries and where governance systems have largely broken down can also be seen as a special problem for the LDCs. The international donor community has, over the recent past, shown willingness to provide assistance in such cases (e.g. Cambodia, Haiti, Rwanda). Recent initiatives to expand the scope of the involvement of the Bretton Woods institutions in post-conflict economic programmes (e.g. specific IMF arrangements for providing support in such situations) should also be of help in this regard.

A variety of approaches has again been suggested for dealing with multilateral debt problems, ranging from an enlarged "fifth dimension", sale of IMF gold, special allocations of special drawing rights (SDRs) and drawing on the reserves and loan loss provisions of the concerned institutions (UNCTAD, 1995b,d). These proposals are designed to provide additional resources for multilateral debt relief without diverting funds from development assistance or increasing the pressure on multilateral donors. Serious consideration of such proposals is timely, as any major initiative designed to alleviate the multilateral debt burden will be fully effective only if the associated funding is additional to ongoing assistance efforts. The ideas that were floated around the time of the Development Committee's meeting in October 1995 on a special multilateral debt facility can also be seen as particularly interesting, as they recognize the need for a comprehensive and concerted approach to the poorest countries' debt problems, that would deal with all components of the country's debt (i.e. including multilateral debt) and aim to achieve overall debt sustainability.

F. Special issues relating to private investment flows

As there are no signs, for the time being, of an easing of the current global ODA shortage, LDC governments have, of necessity, turned attention to non-ODA sources of financing. While it was argued above that these countries as a group are likely to remain at the margin of international capital markets in the foreseeable future, there may be opportunities to attract capital even at the margin, e.g. initially for those LDCs that have experienced stronger growth in response to more outward-oriented policies, and for those that have larger economies and/or are better endowed with natural resources. Without detracting from the pivotal role of ODA in financing LDCs' development, considerable room exists for identifying opportunities to tap the resources available on capital markets and to help LDCs create the conditions for attracting more private investment.

For all developing countries, private capital flows have increased in the last decade, and FDI has become the largest component of these flows. This reflects the central role of transnational corporations in the process of globalization, in particular in technological innovation and diffusion and in wealth creation; increasing recognition by countries including developing countries of the positive contribution transnational corporations can make to development; and the resulting FDI policy liberalization. The proliferation of Regional Trade Areas has also resulted in the liberalization of FDI flows at the regional level. While private flows cannot presently substitute for ODA, least of all in the case of LDCs, they can make a valuable contribution as a supplement to official flows in meeting the external financing requirements of LDCs. In addition, private capital, in particular FDI, provides LDCs with access to innovative technology and to modern management and organizational practices and skills, as well as access to international markets.

Among developing countries as a whole, the most important host region for FDI is the Asia-Pacific region, which accounted for 59 per cent of total developing countries' FDI stock in 1994. Among the LDCs, however, most FDI has so far gone to African countries. But few LDCs have been able to attract significant inflows of FDI and other private capital and thus diversify their external financing base. Private flows constituted over 10 per cent of total net resource inflows in the late 1980s and early 1990s in only six LDCs: these were Gambia, Lesotho, Liberia, Maldives, Tuvalu and Vanuatu (of these, Liberia and Vanuatu both have important off-shore activities) (see annex table 23). These figures reflect private flows from DAC countries only. The discussion of FDI flows in the following is based on a different set of figures, i.e. UNCTAD/DTCI data giving estimates of total investment flows from all sources.

Foreign direct investment in LDCs: recent trends and prospects

FDI flows to LDCs depicted in table 8 indicate that LDCs have captured a negligible share of the boom in FDI to developing countries in recent years: their share in total FDI to developing countries declined from 1.7 per cent on average during the period 1983-1988, to 1 per cent in 1994. On the other hand, while modest in scale, in relation to worldwide investment flows, FDI to the LDCs has nevertheless increased in absolute terms. Inflows averaged over $0.8 billion a year during 1989-1994, as compared with $0.3 billion during the preceding six-year period; and the share of FDI in gross fixed-capital formation in LDC economies more than doubled from an average of 1.8 per cent in 1981-1985 to 4.1 per cent in 1991-1993 (UNCTAD, 1995e, annex table 5). Moreover, developing countries (e.g. newly industrializing economies (NIEs)) have emerged as significant sources of FDI to other developing countries, in particular in the Asia-Pacific region, and some LDCs (e.g. Lao People's Democratic Republic and Myanmar) have benefited from outward FDI from other developing countries in this region.

It was noted above that the aggregate figures for non-concessional resource flows to the LDCs as a group are largely determined by the flows to a few countries. This is also broadly the case for FDI. Excluding the two most dominant and atypical cases - Angola and Liberia - FDI inflows to LDCs averaged not quite $0.5 billion over the period 1989-1994 (as compared with just over $0.1 billion over the preceding six-year period). Moreover, available data indicate that there were substantial profit remittances on FDI, largely offsetting the inflow of such investment during this period. According to World Bank figures, profit remittances from LDCs approached $0.7 billion annually on average in 1990-1993 ($0.3 billion excluding Angola).[15]

Apart from the access to financial resources, other potential benefits of FDI, such as access to technology, skills and international markets, are now widely recognized by LDCs. But the LDCs have few locational advantages that could attract transnational corporations and face stiff competition for foreign investment, both globally and within the developing world. They lack the social and physical infrastructure, the institutional framework and macroeconomic environment conducive for attracting such investments. Poor telecommunication and transportation facilities, a generally unskilled labour force, non-transparent legal and regulatory framework, high levels of external debt, macroeconomic instability, and small domestic markets discourage investment in LDCs. To improve their attractiveness to FDI, many LDCs have in the last decade initiated reforms aimed at alleviating these bottlenecks.

The relatively modest response of FDI to these reforms, to date, suggests that the reforms have to be deepened and/or brought forward. A recent UNCTAD study on FDI, which focuses on Africa but which is relevant for LDCs in other regions as well, discusses some of these issues and puts forward a number of suggestions to improve the environment for foreign investment in these countries, such as to reform and simplify authorization procedures and other regulations, expand privatization linked to foreign investment, improve investment-incentive schemes, reduce restrictions on transfers of capital, create the facilities and skill-base for competitiveness and accelerate promotion campaigns (UNCTAD, 1995a).

To attract more FDI, it is essential for LDCs to upgrade their physical and institutional infrastructure, improve the regulatory environment and education services, to mention a few among the many factors determining the pattern of FDI. However, resources needed for this are unlikely to be provided by LDC governments alone given the fiscal constraints in these countries. Increased levels of ODA may be required to supplement domestic resources, not only for the provision of physical infrastructure and human resource development, but also for designing and implementing further improvements in the regulatory and incentive frameworks.

LDCs also have to promote and/or advertise their potential as investment locations more aggressively. With bilateral or multilateral assistance, these could take the form of promotion events for LDCs to elicit the interest of potential cooperation partners and investors and of targeted marketing campaigns for individual countries and specific investment opportunities. While decisions about investment locations will be made by private companies, decision-making will be facilitated by timely and precise information about conditions, regulations and facilities in individual LDCs on the relevant information networks.

Table 8: Foreign direct investment inflows to LDCs, 1983-1994

	1983-1988 (Annual average)	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*[a]
$ Million							
Total developing countries	19,757	28,622	34,689	40,889	54,750	73,350	84,441
LDCs	337	1,201	423	1,063	740	786	863
African LDCs	310	1,141	190	922	548	526	665
Asian LDCs	10	30	195	86	140	203	143
Percentage shares							
Share of LDCs in total developing countries	1.7	4.2	1.2	2.6	1.4	1.1	1.0
Share of African LDCs in total LDCs	92	95	45	87	74	67	77
Share of Asian LDCs in total LDCs	3	2	46	8	19	26	17

Source: UNCTAD/DTCI (Division on Transnational Corporations and Investment) database on foreign direct investment.

a Estimates.

Box 4: Economic reforms to encourage domestic and foreign direct investment in the Lao People's Democratic Republic

The Government of the Lao People's Democratic Republic continues to restructure its economic policy, in the context of the Socio-economic Development Plan (1993-2000), with the aim of promoting a market-oriented economy with varied forms of ownership, production, distribution and services. The state has removed constraints impeding the development of a free and legal trade system. The Public Investment Programme (1996-2000) reflects the commitment of the Government to sustain and consolidate macroeconomic reforms. The Lao People's Democratic Republic has made considerable progress in its reform efforts in recent years despite many structural and geographical constraints. Real per capita GDP increased by annual average growth rates of 1.6 and 2.6 per cent during the period 1980-1990 and 1990-1993, respectively.

Prior to 1988, almost all investment in the Lao People's Democratic Republic was public investment financed by external aid and lending. After 1988, the Government encouraged private investment, both domestic and foreign. Various laws and regulations were promulgated during 1991-1995 to promote the role of the private sector. These include the Customs Law, Law on Foreign Investment, Labour Law, Land Law, Insurance Law, etc. The necessary judicial and administrative machinery was established. Recognizing the important role played by commercial banks in the development of the market economy, the Government granted licenses for foreign commercial banks to establish branches in the Lao People's Democratic Republic. A number of foreign commercial banks are, at present, operating in the country. In the agricultural sector, the Government has concentrated on measures to promote commercial agricultural production by the private sector. These include expansion of irrigated land and expansion and promotion of credit at the grass-roots level. Processing and small-scale industries of various types have developed rapidly in the main urban areas.

The level of domestic savings remains low. Thus, from the 153 billion kips allocated for public investment in 1994/95, 32 billion kips came from domestic sources and 121 billion kips from external resources. The Government has adopted a two-pronged approach to mobilize domestic savings: first, to increase the effectiveness of the savings mobilization efforts of the public sector by switching from a reliance on non-tax revenue to tax revenue; secondly, through developing the financial infrastructure, the number of savings instruments and through the active use of interest-rate policy. As a result of these measures, domestic revenue as a percentage of GDP is envisaged to increase from 13.1 per cent in 1996 to 16.6 per cent in the year 2000. The projected increase is due mainly to an expected increase of revenue from foreign investment taxes and hydroelectric power projects. The Government would need to ensure that the tax burden does not fall too heavily on the business sector and thus act as a disincentive to domestic investors.

Foreign direct investment includes the following three types: business by contract, joint ventures and wholly foreign-owned enterprises. The investment code specified sectors in which investment was permitted and gave guarantees against nationalization. A package of incentives, including repatriation of profits and tax exemptions, was subsequently issued. With these measures, foreign direct investment has increased rapidly: in 1994, 133 projects were licensed for investment with a total registered value of $2.6 billion and in the first three months of 1995, 29 projects were approved at a value of $551 million. Investment commitments have been evenly spread across sectors, with hotels and tourism and mining and petroleum accounting for the largest shares. Nearly half of the investment is from Thailand, with the United States of America, Taiwan Province of China, France, Malaysia and Australia accounting for the rest. Of the enterprises, 8 per cent have a value exceeding $5 million, but the bulk is relatively small, consisting of less than $1 million.

The Lao People's Democratic Republic, with its prudent monetary and fiscal policy, endowed with rich natural resources, and located at the heart of the subregion, has a substantial development potential and is well suited to attract foreign direct investment. However, to be in a position to realize this, the Government must address some of the shortcomings that are facing the private domestic and foreign investment. These include improvements in the administrative machinery for identifying and approving the quantity and quality of public investment projects, improving the control and monitoring of approved investment projects, ensuring that investment funds are channelled through the banking system, and strict monitoring and control of the implementation of laws and regulations relating to commodities, currency, credit and investment. There is also an urgent need to intensify training programmes in view of the shortage of a skilled labour force.

Market size is one of the most important factors in influencing investment location decisions. As many LDCs have small populations and low per capita incomes, they are at a clear disadvantage (although with sustained growth the larger economies may offer considerable potential to far-sighted investors). This situation is exacerbated by the persistence of extensive barriers to trade among neighbouring LDCs. To enhance their attractiveness to FDI, LDCs have to create larger regional markets through regional trade liberalization (within the context of Regional Trade Areas, and/or making existing Regional Trade Areas functional) or access to NIEs and developed-country markets. In this respect, the Asian and Pacific LDCs may benefit from their location in the most dynamic growth region in the world and/or membership in the Association of South-East Asian Nations (ASEAN), and LDCs in southern Africa from growth in the new South Africa. Overall, LDCs may benefit from cooperative arrangements with other developing countries, e.g. NIEs in Asia and Latin America. While this may facilitate LDCs' access to those commodities and simple manufactures markets being vacated by the NIEs, the LDCs may also play host to increasing FDI originating in these developing countries.

Export platforms, e.g. export processing zones, which grant special facilities to investors to produce for export, have proved to be successful not only in attracting FDI to developing countries like Mauritius and the Dominican Republic, but also in making significant contributions to the overall economic growth of these countries. While there may be limits to the number of LDCs that can successfully utilize export processing zones to promote FDI, the potential of such zones is yet to be fully exploited by LDCs.

One significant trend in FDI is the increasing importance of services, which have become the fastest-growing component in trade and in FDI. Services now account for three fifths of total FDI flows. Trade in services offers developing countries unique opportunities to move into new export markets and to attract different types of investment. To capture these opportunities, LDCs, as other countries, will need to adapt their regulatory environments and develop supportive physical and human infrastructure (World Bank, 1995b). Both to attract FDI in general and to enhance their competitiveness in service-related new areas, LDCs need to improve the quality of pre-work education and technical training as well as on-the-job training in LDCs, e.g. through technical cooperation agreements and partnership with the private sector to facilitate access to new telecommunications or information technology.

Overall, a stable political and macroeconomic environment which ensures policy predictability and transparency, realistic exchange rates and low and stable rates of inflation are major factors affecting the direction of FDI.

Other private investment flows

Apart from FDI, portfolio equity investment is another possible source of foreign private investment. So far, no significant flows of this type to LDCs have been reported in available statistics on external resource flows to these countries. From the perspective of identifying new opportunities available to LDCs in the globalizing economy, however, the conditions for and the potential of increasing recourse to this type of financing merits analysis. In this respect, LDCs will be able to draw on the experiences of other developing countries as well as of those countries within the group which have already taken the first steps towards developing equity markets. As their economies grow stronger and their financial sectors develop, and conditions of political and macroeconomic stability are established, other LDCs could follow suit.

Bangladesh, one of the strong-growth LDCs as well as being a relatively large country in terms of population and GDP, has already tapped the international equity markets several times in recent years. Moreover, the Dhaka Stock Exchange is relatively well established and can be seen as an important emerging market. Several country funds targeting Bangladesh have been set up (for instance, several Hong Kong-based funds). Zambia and Nepal opened their first stock exchanges in 1994. In Africa, share markets were being planned or in the process of being set up in several other LDCs, such as Malawi, Uganda and the United Republic of Tanzania. Venture capital funds focusing on Africa have also been launched, from which these and other African LDCs could hope to benefit.

LDCs thus need not remain outside world capital markets altogether, especially if their economic conditions improve. If they take the necessary steps to develop and reform their financial sectors, they may ultimately be able to attract increased foreign investment. Important lessons might be learned from the experience of Botswana, the one country that has so far graduated from the category of LDCs, and which has a relatively well-developed financial sector. A stock market (the Botswana Share Market) was established in this country in 1989, and, although small, it has grown rapidly since that time. An initial assessment of its contribution to capital-market development in Botswana found that the share market had a major impact on the portfolio composition of domestic institutional investors, reducing their incentive to invest offshore, but only a small impact on inflows of foreign investment (Jefferis, 1995). However, a significant increase in buying by non-resident investment funds was reported in 1994. This country is now charting the course of "going international", a challenge that those countries remaining in the LDC category also have to face. ◘

Notes

1 Figures communicated by the OECD secretariat.

2 In comparison, from a level of $57.8 billion in 1992, ODA flows to all developing countries from the DAC countries and multilateral agencies mainly financed by them fell to $54.1 billion in 1993, then recovered to $58.4 billion in 1994.

3 In this chapter, Botswana has been excluded from the first group and Eritrea included in the last group (see table 6).

4 In recent years, between 30 and 45 per cent of all ODA channelled through the various aid programmes of the European Union has been allocated to LDCs.

5 France was the largest source in 1991.

6 The share of Luxembourg increased from 0.07 per cent in 1990 to 0.12 per cent in 1993. Figures for 1994 were not available for Luxembourg at the time of writing this report.

7 Figures communicated by the OECD secretariat.

8 In the 1994-95 edition of the *World Debt Tables* (World Bank, 1994), 26 of the LDCs were classified as severely indebted and another nine as moderately indebted. The severely indebted low-income group of 33 countries identified by the World Bank is thus mostly composed of LDCs. LDCs where the severity of external indebtedness has increased over the recent past include Chad, Central African Republic, Guinea, Rwanda, Samoa and Yemen.

9 Estimates based on World Bank, 1994; see also UNCTAD, 1995b.

10 Not including Eritrea, which only recently became independent and was not yet covered by the 1994-95 edition of the *World Debt Tables* (World Bank, 1994). The six LDCs in question were Burkina Faso, Cambodia, Djibouti, Haiti, Kiribati and Vanuatu.

11 For example, Chad and Guinea-Bissau, classified as "strong-growth" LDCs, both turned to the Paris Club in early 1995; also, their export performance was weakest among the LDCs in this group.

12 In the case of Uganda, the debt covered by the agreement was limited by a high *de minimis* level and the exclusion of some previously rescheduled debt. (The *de minimis* level of debt is a specified minimum amount of debt which is covered by the rescheduling agreement. Creditors whose claims are less than this specified amount do not participate in the agreement.) The stock treatment did not include the totality of outstanding eligible debt, as it related to the debt covered by some, but not all previous consolidation agreements with the Paris Club. Moreover, as is standard practice in the Paris Club, only debt contracted before a specified cut-off date is eligible for rescheduling. Usually the cut-off date is determined at the first rescheduling and will remain unchanged in subsequent reschedulings; this can lead to large parts of debt due to Paris Club creditors being excluded from debt forgiveness and other relief measures.

13 RAPs are available to member countries in protracted arrears at the end of 1989. Four LDCs - Liberia, Somalia, Sudan and Zaire - still have obligations to the IMF overdue by six months or more, and remain ineligible to use the general resources of the Fund. These four LDCs, as well as Afghanistan, were also in arrears on repayments on IDA credits and in non-accrual status with the World Bank.

14 Various types of debt-for-development and other debt-conversion schemes may also be mentioned, although so far they seem to have been implemented only to a limited extent in LDCs.

15 Estimates based on World Bank, 1994.

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PART TWO

Selected Issues in the Context of Interdependence

PART TWO

I. Globalization and Liberalization: Implications for LDCs

II. The Uruguay Round, Trade Diversification and the LDCs

III. Regional Trading Arrangements and LDCs

Introduction

Globalization and liberalization have had profound effects on developments in the world economy and on the economies of individual countries in recent years. This part of the LDC 1996 report examines how these two interrelated processes affect the development prospects of the LDCs. Chapter I provides an overview of some of the key aspects of globalization and liberalization affecting LDCs, including the opportunities emerging in the global economy which LDCs may be able to exploit to revive their economic development and the dangers that these phenomena entail for them. The concluding part of Chapter I discusses policy measures to deal with the effects of globalization and liberalization. The following two chapters analyse the possible consequences for LDCs of specific aspects of globalization and liberalization. Chapter II discusses the implications for LDCs of the Uruguay Round of multilateral trade negotiations, while Chapter III considers the potential impact of the growing importance of regional trading arrangements, and whether LDCs can advance their own trading and development interests through membership of such arrangements.

I. Globalization and liberalization: Implications for LDCs

A. Introduction

Globalization has become an increasingly dominant feature of the world economy over the last decade. It is a multifaceted phenomenon, salient characteristics of which include rapid growth of international trade and capital flows, the increasing importance of services in both trade and foreign direct investment (FDI), the global integration of production processes, and institutional harmonization among countries with regard to trade, tax and investment policies, and other regulations (Sachs and Warner, 1995, pp.1-2). Economic relations between nations are increasingly conditioned by the disciplines of multilateral institutions such as the World Trade Organization (WTO) and regional groupings.

The global economy has also become more liberalized as almost all countries throughout the world have adopted market-oriented policies entailing the reduction of government intervention and the privatization of state-owned assets. While liberalization has contributed to global economic integration by removing barriers to trade and investment, it is also a response to it, as governments' ability to control economic events within their own borders has progressively diminished. The imperatives of technology, the contractual obligations of governments to multilateral institutions and the lack of realistic alternative economic strategies suggest that barring a major breakdown in international trade and economic relations, globalization and liberalization are almost certain to characterize the period ahead, although the pace at which global integration will proceed is difficult to predict.

The impetus for globalization has come from three directions. First, institutional barriers to international trade and capital flows have been removed or reduced across a wide range of countries, partly as a result of multilateral or regional agreements to enhance market access (General Agreement on Tariffs and Trade (GATT), European Union (EU), North American Free Trade Agreement (NAFTA), etc.) and partly through unilateral liberalization. The latter has been particularly prominent among developing countries (DCs), large numbers of which have dismantled protectionist import regimes and restrictions on capital transactions since the mid-1980s.

Secondly, technological advances in transport and electronic communications have significantly reduced the cost of trade. Technological progress has made viable the export of a range of goods and services that previously were effectively non-tradeable, such as many service industries.

Thirdly, productive processes, especially those controlled by multinational corporations (MNCs), have become more dispersed geographically: many different countries may have supplied the materials, components, services and assembly work that go into the production and distribution of a final product. Sometimes referred to as "deep integration", this has been spurred by the growing share of world output controlled by MNCs - intra-firm trade now accounts for around 40 per cent of world trade - and facilitated by the technological advances noted above (Cook and Kirkpatrick, 1995, pp.2-10).

While the expansion in world trade and capital flows was initially confined mainly to the developed market economies (DMEs) and a relatively small group of newly industrialized economies (NIEs), many other DCs have become increasingly integrated into the world economy since the mid-1980s, as evidenced by the rapid growth in capital flows, for example, to some of the countries of East Asia and Latin America. Integration into the world economy is seen by governments in these countries as an essential component of their development strategies, providing opportunities for growth that cannot be derived from inward-looking economic policies. This is a view which is also held by the international financial institutions and the donor community (World Bank, 1995). The impact of global integration and liberalization on the economic development of many of the LDCs may not, however, be so sanguine.

This report argues that the processes of globalization and liberalization offer LDCs important long-term opportunities to reverse the economic decline that they have experienced over the last two decades, but that these processes also raise serious concerns for these countries. More than any other group of countries in the world, the LDCs, with only a small number of exceptions, have become marginalized from the mainstream of global economic activity and from sharing in its benefits. Globalization may do little to alleviate this trend towards marginalization and may accentuate it.

Marginalization in this context connotes the decline in the LDCs' share of world trade, capital flows and production to negligible levels, with severe consequences for their development and living standards. Given the importance of trade and FDI flows in stimulating and facilitating technological innovations, the implication of this marginalization is that LDCs will fall even further behind the rest of the world in terms of their technological capacities. In some LDCs, marginalization may also involve the emigration of scarce factors of production, such as professional and skilled labour and capital, in search of higher returns abroad.

The economic performance of the LDCs has not been homogenous: a significant minority of the group have made significant progress over the course of the last two decades, achieving strong export growth and steady increases in per capita output. However, the economies of around three quarters of the LDCs have deteriorated markedly since the mid-1970s, and this is reflected in the declining shares of world trade, investment output and income of the LDC group.

LDCs have already suffered a steady erosion in their share of world exports and FDI since the 1970s (table 9). Their export performance, in particular, has been very poor: they have lost their market shares for their traditional primary products in world markets and have failed to diversify into non-traditional products (see, in section C, Trends in markets for primary commodities). It is evident, therefore, that for most of the LDC group, marginalization from the world economy is a process that has been under way for some time. The causes of this marginalization include external shocks such as falls in the terms of trade, natural disasters such as droughts, and economic mismanagement and political instability.

Interrelated with the marginalization of LDCs from world trade and capital flows is the persistent decline in their share of world income and output. LDCs' share of world GDP fell from 0.6 per cent in 1980 to 0.4 per cent in 1993 (table 9). Their share in world income has declined mainly for two reasons: the output of their economies has stagnated, or grown at a much slower rate than elsewhere in the world, and they have suffered significant losses in terms of trade. Although the fall in their share of world income is attributable partly to developments that are endogenous to the LDCs, it also reflects more widespread trends in the world economy. Growing income inequality between countries appears to be a significant feature of the process of global integration with adverse effects not just on LDCs, but also on many other low-income DCs, which are falling further behind the developed and newly industrializing countries in terms of living standards.[1]

Table 9: LDCs' share of world exports, imports, foreign direct investment and GDP: 1980 and 1993
(Percentages)

	1980	*1993*
Exports	0.7	0.4
Imports	1.1	0.7
FDI inflows	0.9	0.4
GDP	0.6	0.4

Source: UNCTAD database.

Box 5: Convergence or divergence: Opposing views of the effects of globalization on world-income distribution

Two opposing views have been propounded regarding the impact of globalization on world-income distribution: these have been called the convergent and divergent views (Cook and Kirkpatrick, 1995). On one side are those who take a benign view of the effects of globalization, arguing that it will lead to "convergence"; i.e. that income inequalities between countries will diminish as the economies of the poorest countries grow more rapidly than those of the richest. Convergence between DMEs and DCs is consistent with long-standing tenets of economic and development theory in which rates of return to capital diminish as it becomes more abundant relative to labour. As capital in DCs is in scarce supply, its rate of return should exceed that in DMEs. In the absence of barriers to capital mobility, capital will flow from DMEs to DCs in search of higher rates of return, raising growth rates in DCs and closing the income gap with the DMEs. The convergence view also draws support from conventional trade theories, such as the Hecksher-Ohlin model, which stress the welfare-enhancing effects of international trade. Trade between countries with different factor endowments (e.g. between DCs and DMEs) should raise returns to the relatively abundant factor in each country (and reduce returns to the scarce factor), and therefore lead to a diminishing of global differences in wage rates and consequently incomes.

The opposite "divergent" view is that most of the benefits of globalization accrue to the already industrialized countries, together with a relatively small number of NIEs, and that globalization is therefore exacerbating income inequalities between the richest and poorest countries. What is not in dispute is that, when viewed in terms of per capita incomes, the world economy has not "converged" over the last two to three decades: the ratio of the incomes of the richest 20 per cent and the poorest 20 per cent of the world’s population increased from 13:3 in 1960 to 17:7 in 1991 (see box 6).[1] What is contentious is the explanation for this growing inequality.

Proponents of the "divergent" view point to the difficulties that DCs face in deriving benefits from participating in the international economy to explain the growing inequality in world incomes. These include declines in the terms of trade for primary commodity exports, the "fallacy of composition" argument (that import markets in the DMEs are not large enough to absorb increased exports from all DCs), protectionist barriers in the DMEs to imports from DCs, the impact of the DCs’ external debt burden on net transfers of resources, and restrictions on labour migration from DCs to DMEs. The unfavourable international economic climate, it is argued, has imposed a severe constraint on the import capacity of DCs, which in turn has depressed their economic growth rates (Cook and Kirkpatrick, 1995, pp.14-16). In addition, Griffin and Khan (1992) contend that the conventional theoretical argument for convergence - that returns to capital are higher in DCs than in LDCs - is incorrect. Higher expenditures on the education and training of the workforce, increasing returns to scale and other externalities, and the adoption of technical innovations in the DMEs combine to raise rates of return to capital in these countries to the point where they exceed those in DCs. Consequently, the direction of capital flows is perverse: from poor to rich countries. Proponents of the divergent view argue that reforms in the international economy with regard to trade between DMEs and DCs, debt relief, the control of capital flows, the distribution of aid, and immigration policies in the DCs, are necessary to ensure a more equitable distribution of the benefits of globalization.

The convergent view of globalization found support in a recent article by Sachs and Warner (1995). They argue that the economies of those DCs that pursued open-trade policies - low tariffs and NTB coverage, etc. - and were thus most closely integrated into the world economy, have converged with the DMEs: Barbados, Mauritius, Singapore and Thailand are cited as examples. Their economic performance, in terms of growth rates and structural change, was far superior to that of (a much larger group of) DCs which were more closed to international trade: i.e. those that imposed greater restrictions on imports and exports. The absence of convergence between DMEs and this latter group of DCs is attributable, therefore, not to globalization but to its opposite: the lack of integration into the global economy of this group of DCs is a result of their restrictive trade policies. The conclusion that Sachs and Warner draw is that all DCs can improve their economic performance by adopting liberal trade policies.

[1] Other indicators of "human development", such as health and educational attainment, show a greater convergence between DMEs and DCs as a result of marked improvements in the latter.

Box 6: Has world income become more unequal?

There is widespread concern that the distribution of world income has become more unequal over the last few decades and that growing inequality is an inevitable concomitant of globalization. The reality of trends in world-income distribution are, however, more complex than is often understood. Whether or not world incomes have become more unequal depends upon the measures of income employed and the definition of inequality, but some of the poorest countries have undoubtedly become worse off relative to the rest of the world.

One of the most widely used methodologies for evaluating income-distribution changes through time is the Lorenz curve and the associated Gini coefficient. The Lorenz curve illustrates the cumulative share of income accruing to progressively richer percentage divisions (such as quintiles which are used in the Lorenz curves shown below) of an income distribution at a single point in time, while the Gini coefficient is a statistic derived from the Lorenz curve. A Lorenz curve of world-income distribution can be constructed using the GDP (or a similar measure of income) of every country in the world, although this does not take into account the income distribution within each country.

The Lorenz curves shown below illustrate the distribution of world incomes in 1960 and 1991. The measure of income used is the purchasing power parity (PPP) per capita real GDP in dollars ($GDP) of every country in the world (some of the smaller countries and most of the former communist countries in Eastern Europe are omitted for lack of data). The use of PPP measures of GDP provide a much less unequal estimate of world-income distribution than do $GDP measures constructed using the Atlas Methodology (which converts local currency estimates of GDP into dollar equivalents using the exchange rate), mainly because the prices of non-traded goods in poorer countries relative to those in richer countries do not reflect the relevant exchange rates.These two methodologies also give different impressions of the trends through time in world income distribution.

The two Lorenz curves shown below provide an ambiguous picture of the trends in world-income distribution over the last three decades. In fact the Gini coefficient declined marginally between 1960 and 1991, which indicates a slight reduction of income disparities when the full range of incomes is taken into consideration, although this fails to take into account changes in intracountry-income distribution which may have worsened during this period. What has actually occurred is complex and is the result of three separate trends among different groups of countries.

First, there was little change between 1960 and 1991 in the share of world income accruing to the countries that comprise the richest 20 per cent of the world's population. Secondly, the middle quintile of the income distribution registered a substantial increase in its share of world income (from 6.9 per cent in 1960 to 10.8 per cent in 1991). This reflects the rapid growth in incomes in some of the larger Asian economies such as China. Thirdly, the quintiles which suffered a reduction in their share of income were the second richest quintile, and, more worryingly, the poorest quintile. The latter experienced a fall in its share of world income from 4.9 per cent in 1960 to 3.6 per cent in 1991. Furthermore, the income disparity between the richest 20 per cent of the world's population and the poorest 20 per cent widened markedly in this period: the mean per capita income of the richest quintile was 13.3 times that of the poorest quintile in 1960 compared to 17.7 times in 1991. From the standpoint of the poorest countries, the world has become more unequal over the last three decades.

There is a close correspondence between the countries that comprised the poorest quintile in 1991 and the membership of the LDC group. The poorest quintile was comprised entirely of LDCs with the exception of Ghana and India (which straddled the poorest and second poorest quintiles) in 1991. Moreover, of the 31 LDCs for which PPP GDP estimates are available, 27 fell into this quintile. The falling share of world income accruing to the poorest quintile is indicative of the fact that the growth rate of the LDCs' economies did not keep pace with that of the rest of the world during 1960-1991.

Table: Distribution of world income by quintiles

Quintile	*1960 Real GDP per capita[a] (PPP$)*	*1960 % of world income*	*1991 Real GDP per capita[a] (PPP$)*	*1991 % of world income*
First	7,132	64.4	17,366	63.7
Second	1,961	17.7	4,294	15.7
Third	767	6.9	2,933	10.8
Fourth	678	6.1	1,692	6.2
Fifth	537	4.9	973	3.6
Mean income	2,215		5,452	
Ratio of richest to poorest quintile	13.3		17.7	
Gini coefficient[b]	0.523		0.519	

Source: UNCTAD secretariat, based on UNDP data provided by the Human Development Report office, UNDP.

[a] Purchasing power parity per capita real GDP.

[b] The Gini coefficient takes a value between 0 and 1: higher values denote greater inequality.

B. Globalization and liberalization: opportunities and constraints

The completion of the Uruguay Round of GATT, combined with further unilateral liberalizations, will reinforce the trends towards global economic integration, providing both opportunities and challenges for LDCs. It is likely that the growth of world trade will accelerate and will encompass products not previously traded internationally. This will provide an impetus to continued income growth in DMEs and an acceleration of income growth in DCs. Merchandise trade is projected by the World Bank to grow at 6 per cent per annum over the next decade provided that liberalization in the world economy continues. Trade in services is expected to expand even more rapidly (World Bank, 1995, pp.5, 15).

Future market opportunities for LDC exporters should be significantly enhanced by globalization, multilateral trade liberalization and related trends in the world economy for a variety of different reasons.

First, for products not covered by preferential trading arrangements, the reduction of trade barriers entailed in the UR may improve market access in the main export markets.[2] Secondly, export markets in general will expand as a result of income growth in the importing countries and the opening-up of new markets in previously closed economies, such as the former communist countries. Thirdly, the dynamic growth of the Asian economies, many of which lack natural resources or that are facing increasingly severe constraints in the production of primary commodities (e.g. because of scarcities of arable land) may provide a stimulus to world demand for primary commodities such as beverages and foodstuffs, agricultural raw materials, minerals and timber, for which many LDCs have a comparative advantage and well-established production and marketing facilities. Fourthly, the combination of income growth, changing consumer tastes and agricultural liberalization in the DMEs may create a potentially vast market for LDC exporters of high-value agricultural products, such as exotic fruits and vegetables, which have not previously formed a major component of LDCs' traditional exports. World market demand for many horticultural and fish products is currently growing rapidly. This will provide LDCs with important opportunities for export diversification. Fifthly, many LDCs have important natural resources (e.g. wildlife) which can be used to attract a share of the rapidly growing market for international tourism. As natural habitats are destroyed by human activities throughout the world, those countries that can still offer tourists the chance to visit unspoilt natural attractions, such as the game parks of Africa, will be able to charge substantial premiums derived from scarcity rents for this type of eco-tourism, provided that they are able to protect their ecological assets and develop adequate tourist facilities.

Sixthly, largely because of technological advances, it has become possible and profitable to separate the work entailed in the production of many products, both goods and services, into disparate components which are often undertaken in different countries to take advantage of differences in factor costs. This "slicing up" of the value-added chain is one of the reasons why world trade has expanded at a much faster rate than world output. It has enabled a number of low-wage developing economies to establish manufacturing export industries which carry out labour-intensive operations on semi-finished imported inputs which are then exported, either as final goods or for further processing elsewhere (Krugman, 1995, pp.333-336). Hence, it has greatly expanded the opportunities for developing economies to participate in the international trade in manufactured products. While few of the LDCs have so far been able to establish labour-intensive manufacturing export industries, the prospects should be much brighter in the future for two reasons. Economic policy reforms have improved the policy environment for the private sector in general, for foreign investment and for exports in many LDCs (e.g. LDCs are maintaining more competitive exchange rates and have introduced regulatory and fiscal reforms to provide incentives for FDI). Moreover, as economic development in the NIEs raises their wage levels and production costs, these countries are beginning to lose their comparative advantage in some of the products that provided an initial stimulus to their growth as successful exporters. Firms in these countries are likely to seek alternative, less expensive, locations for labour-intensive production processes, such as the assembly of garments, which may offer opportunities for LDCs to attract investment in these sectors.

Given that the domestic markets of most DCs are very small, the increased access to export markets that global liberalization may bring about offers important opportunities for LDCs to exploit natural resources and economies of scale in developing more productive and competitive industries. If LDCs can take advantage of some of these opportunities in the globalizing world economy, the implementation by LDCs of outward and market-oriented economic policies should bring about an improved economic performance, allowing them to utilize scarce resources in a more efficient manner, providing a stimulus to private-sector development and raising economic growth rates.

Unfortunately, enhanced access to expanding global markets is probably not sufficient to enable the LDCs to benefit from globalization. LDCs require efficient production structures capable of meeting increasingly exacting demands of quality, cost and delivery schedules on international markets. The institutional units for such production are mainly private-sector enterprises supported where necessary by the efficient provision of public goods and services. Many DCs in East Asia and more recently in Latin America have, over the last two decades, fostered the growth of internationally competitive enterprises and have consequently recorded rapid growth in exports, as well as diversifying away from primary commodity exports to manufactures. For these countries, globalization has clearly been a crucial factor in their development into NIEs: they have successfully utilized foreign technology, and in some cases foreign capital, to expand into international markets. In a world of increasing capital mobility, they have become important locations for FDI, while some of their domestic companies have begun to invest in production facilities abroad, including in the OECD countries.

In contrast, the private sector is very weak in most LDCs. Its growth has been retarded by a variety of factors, including economic policies that failed to provide it with adequate incentives. Although liberalization has improved the policy climate, major obstacles to private-sector development remain. Savings rates are low so firms face difficulties in raising capital for investment. Because of the weaknesses of domestic financial institutions, trade credit and preshipment finance is often either unavailable or expensive. Entrepreneurial, managerial, marketing and technical skills are very scarce, as are entrepreneurs with the experience of producing for export markets. Deficiencies in the physical infrastructure are a major impediment to competitive production. Many of the LDCs are land-locked countries that face extremely high transport costs to access international markets. A legacy of economic and political instability discourages FDI and encourages capital flight. Exporters often lack a variety of necessary support services such as storage facilities and marketing and information services, in some cases because the scale of domestic production is too small to warrant the provision of these services without public subsidy (Cosgrove, 1994, pp.240-241).

Unless there are major improvements in LDC capacities to produce internationally competitive goods, the benefits of globalization will probably remain limited. Such improvements are unlikely to occur unless domestic policies backed by international support are directed at the supply-side deficiencies in LDCs.

C. Disadvantages of globalization and liberalization: threats of further marginalization

This section discusses a number of issues related to the trends towards global economic integration and liberalization that are of potential concern for LDCs because they threaten to exacerbate their marginalization in the world economy. These include: the tendency for private capital flows to be increasingly concentrated in the richest and more dynamic economies of the world; the impact of trade liberalization on domestic industries; the declining importance of primary commodities in world trade combined with the LDCs' loss of market share in world primary-commodity markets; the formation and expansion of regional trading arrangements, most of which do not include LDCs; and the consequences for LDCs of certain aspects of the Uruguay Round of GATT.

Concentration of capital, technology and skilled labour in more advanced regions of the world

The importance in the global economy of private capital in general, and of MNCs in particular, has become more pronounced over the course of the last decade. In part, this is because the public sector in both DMEs and DCs has retreated from direct participation in production, but it probably also reflects the impact of the rapid rate of technological innovations that have reinforced the dominant position held by MNCs. MNCs have become increasingly important in the world economy as the institutions most capable of generating technological innovation and creating wealth. Hence, governments in both industrialized and developing countries compete aggressively to attract FDI.

The bulk of private capital flows is between DMEs, but private-capital flows to DCs have grown very rapidly in the last few years - from an annual average of $19.7 billion during 1983-1988 to $84 billion in 1994[3] - and their magnitude has overtaken that of official capital inflows and aid combined. However, the distribution of private-capital inflows among DCs has been very uneven. Capital has been concentrated in the more advanced and dynamic DCs, especially those in East Asia and Latin America, where investment opportunities are greatest. LDCs have, to a large extent, been excluded from the revival in FDI and other forms of private financial flows (such as portfolio investment). Inflows of FDI to LDCs amounted to approximately $900 million during 1989-1991: although this was three times the annual average of $300 million during the preceding six- year period, the rise was largely accounted for by inflows to just two LDCs. LDCs' share of global FDI inflows was marginal, amounting to 0.4 per cent in 1992-1994, while their share of total FDI inflows to all DCs amounted to only 1.1 per cent in the same period (table 10).

Foreign investment in LDCs has been discouraged by a variety of factors including falling world demand for their primary-commodity exports, the small size and stagnant growth of domestic markets, the deficiencies of physical infrastructures, shortages of skilled workers, and acute political instability (UNCTAD, 1995a, pp.62-65). Several MNCs, including some with a long-established presence in these countries, have recently disinvested from, or sharply scaled back their operations in, African LDCs, in order to focus their activities on other regions of the world.[4]

Although the data to substantiate this are very limited, it is likely that the concentration of capital in the more advanced regions of the world has also been accompanied by similar trends in skilled, and particularly professional, labour. The wide differentials in salary levels between those prevailing in LDCs and those in many middle-income DCs, as well as the DMEs, provide a strong incentive for emigration from LDCs.

The trends discussed above are likely to have a number of adverse consequences for economic development in LDCs. Capital flight and brain drain will accentuate shortages of the most productive factor inputs. LDCs' difficulty in attracting FDI threatens to exclude them from the major source of technological innovation in the world, thus exacerbating their technological weaknesses. If technological development has significant positive externalities (i.e. improvements in technology in one firm or sector-boost productivity elsewhere), then technological weaknesses may become self-reinforcing and thus a further barrier to attracting FDI. Moreover, LDCs require major infrastructural investments to facilitate the development of internationally competitive industries. External finance for infrastructure was traditionally supplied by official sources, but MNCs have begun to play a significant complementary role in this area, especially in telecommunications.

Table 10: LDCs' share of world inflows of foreign direct investment, 1983-1994

	Annual average		
	1983-1988	*1989-1991*	*1992-1994*
Inflows of FDI to LDCs ($ billions)	0.3	0.9	0.8
LDCs' share of world FDI inflows (%)	0.4	0.5	0.4
LDCs' share of DCs' FDI inflows (%)	1.7	2.6	1.1

Source: UNCTAD, 1995b, table 1, pp.391-396.

Domestic trade liberalization

The liberalization of domestic trade regimes has exposed domestic import-substituting industries in LDCs to much fiercer competition from imports, especially from the more industrialized DCs. The ability of many of the industries in LDCs to respond to competition is impeded by inefficiencies that are due to excessive levels of protection and inappropriate technology, obsolete equipment that results from a lack of investment, and the inadequacies of infrastructure and supporting services. While liberalization will undoubtedly benefit consumers in LDCs, and ultimately their economies if it provides the stimulus to the development of more efficient and competitive industries, many of the existing import-substituting manufacturing firms are unlikely to survive. This will have social costs as workers lose their jobs. Cheap labour alone will not be sufficient to enable LDCs to penetrate export markets for manufactures because they lack complementary factors of production, especially the skilled labour, infrastructure and technology discussed above.

Trends in markets for primary commodities

Most LDCs rely heavily for export earnings, and often government revenues, on exports of primary commodities, of which oil, copper, coffee, cotton and precious and semi-precious stones are among the most important. Although export diversification into manufactured goods or traded services is a policy objective of a number of LDCs, developing non-traditional export industries has been a difficult and protracted process, and as such commodity exports have retained their importance for most LDCs. This situation is unlikely to change in the foreseeable future. Trends in world commodity markets, however, have not been favourable for LDCs over the last decade: primary commodities have become less important in terms of their share of total world exports, and the share of LDC exports in world commodity markets has been eroded.

There has been a long-run decline in the prices of primary commodities, relative to those

Table 11: Share of commodities of interest to LDCs in world trade

Commodity	*Share of commodity in total LDC exports*	*Share of commodity in world exports*	
	1993	*1983*	*1993*
Fuels	24.4	21.27	23.31
Coffee	3.5	0.51	0.18
Cotton	4.3	0.35	0.15
Fisheries commodities	2.8	0.87	1.00
Tobacco	1.6	0.23	0.14
Tea	0.9	0.11	0.06
Jute	0.5	0.01	0.003
Copra	0.1	0.005	0.002
Wood, non-coniferous	4.2	0.48	0.53
Metals and minerals[a]	13.1	3.81	2.83
Copper	7.5[b]	0.16	0.36[b]
Hides and skins	0.3	0.22	0.13
Total	**63.2**	**1.531**[c]	**1.196**[c]

Source: UNCTAD database.

a Includes iron ore, other metalliferous ores, precious metals and stones and crude minerals.
b 1992.
c Weighted average (based on commodity shares in LDC exports) excluding petroleum.

Table 12: LDCs' share of world commodity markets

Commodity	*Share of commodity in total LDC exports*	*LDCs' share of world markets*	
	1993	***1983***	***1993***
Fuels	24.4	0.75	1.14
Coffee	3.5	13.90	8.00
Cotton	4.3	8.29	11.78
Fisheries commodities	2.8	1.65	1.15
Tobacco	1.6	3.64	4.80
Tea	0.9	7.35	5.71
Jute	0.5	86.81	80.58
Copra	0.1	30.79	31.70
Wood, non-coniferous	4.2	2.82	3.21
Metals and minerals[a]	13.1	3.97	1.88
Copper	7.5[b]	10.34	8.36[b]
Hides and skins	0.3	2.34	1.05
Total	63.2	7.47[c]	6.17[c]

Source: UNCTAD database.
a Includes iron ore, other metalliferous ores, precious metals and stones and crude minerals.
b 1992.
c Weighted average (based on commodity shares in LDC exports) excluding petroleum.

of manufactured goods, on world markets since the 1970s. This decline is unlikely to be reversed and may accelerate for several reasons. First, growth in demand for primary commodities on world markets is lagging behind that of other goods and services because of changes in the sectoral composition of world output: service industries that are not commodity intensive are becoming more important relative to commodity-intensive manufacturing industries. Secondly, technological advances have led to the increasing use of substitutes for, or greater economy in the use of, raw materials, especially metals. Thirdly, productivity increases arising from the application of new technology have brought about an expansion of supply in some countries, especially in agriculture and including crops that are of particular interest to LDCs, such as coffee and cotton (Maizels, 1987, p.543; Reinhart and Wickham, 1994, pp.198-203).

The fall in the real prices of primary commodities has been accompanied by a fall in their share of total world exports; i.e. they have become less important in terms of world export demand. The 12 most important primary commodities, by absolute value, exported by LDCs in 1993 are listed in tables 12 and 13: these commodities accounted for 63 per cent of LDCs' total export earnings in 1993. Table 11 shows the share of each of these commodities (from all exporting countries) in total world exports in 1983 and 1993. Eight of the twelve suffered a decline in their share of world export markets between 1983 and 1993, including two -- coffee and cotton -- which are among the main export earners of numerous LDCs in Africa. Weighted by their share in total LDC export earnings, the average fall in the market share of all these commodities, excluding petroleum, was 22 per cent.[5]

Of equal concern to LDCs is the declining share of their commodity exports in the world markets for these commodities. Table 12 shows the shares of LDC exports in the world markets in 1983 and 1993 for each of the 12 primary commodities of greatest importance to LDCs.

LDCs have suffered major losses of market share for coffee, copper, and metals and minerals. On a weighted average basis (again excluding petroleum), the loss in LDC market share amounted to 17 per cent (from 7.5 per cent of world markets in 1983 to 6.2 per cent in 1993). These losses in market share have arisen for two reasons. First, a number of commodity-exporting countries outside the LDC group have attained major productivity improvements, and as a result have expanded production and gained market share at the expense of LDC exporters. Secondly, in many LDCs, a variety of domestic problems, including adverse pricing and marketing policies, shortages of capital and foreign exchange for investment, natural disasters and security problems have led to a stagnation, and in some countries a sharp reduction, of commodity production.

The Uruguay Round

The UR, which was concluded in 1994, marked the beginning of significant transformations in the global economic and trade environment. The available evidence suggests that the UR will have beneficial effects globally by engendering a multilateral trading system that will stimulate world trade and produce long-term efficiency gains. In the long term, the UR will contribute to globalization by enhancing the access of DC exports to DMEs which account for the bulk of world imports.[6] However, initial gains would accrue to already successful DC exporters (NIEs).

The potential gains of the UR for LDCs will be constrained by a number of factors. First, the share of LDC exports in world trade is minuscule and is declining consistently. Secondly, globalization is characterized by increases in the shares of services and high-technology goods in world trade, but LDC exports are dominated by primary commodities. Thirdly, tariff reductions for "sensitive" labour-intensive LDC manufactures, such as textiles and garments, leather products and processed primary products, e.g. fish, are below average.

In addition, LDCs may face a variety of transitional costs in adjusting to more competitive global markets. These costs centre around three areas. First, preference erosion, that is the diminution of trade-preference margins following the phasing-out of the Multi-Fibre Arrangement (MFA) and reductions in most favoured nation (MFN) tariffs. Secondly, there is the possibility of higher prices for food, and other critical imports, like pharmaceuticals and technology, because of the agreements on agriculture and trade-related aspects of intellectual property rights (TRIPs). Thirdly, transitional costs are associated with compliance with notification requirements, policing the TRIPs agreement, and increased participation in WTO activities (see Part Two, chap.II for a discussion of these issues).

Some unresolved issues may yet influence the UR's effect on LDC integration into global markets. These include the trend towards regionalism (see below) and the unfinished UR agenda on "non-trade" issues, such as the relationship between the environment and labour standards on one hand, and trade on the other, which could as yet jeopardize the projected benefits of the UR for LDCs. There is the possibility of new barriers being erected by DMEs that could limit LDC trade expansion: e.g. escalation in the use of anti-dumping policies and countervailing duties, and abuse of the selective safeguard mechanism.

Much of the prognosis about the effects of the UR is by no means certain, as the lack of clarity on some issues prevents unambiguous conclusions of specific effects from being drawn.[7] There is the probability that the UR will increase LDC participation in global trade. First, there may be the potential for increased exports from LDCs as a result of higher world demand. Secondly, the binding of MFN tariff reductions, and to a lesser extent, the tariffication of non-tariff measures (NTMs) by making NTMs more transparent, may enhance LDC market access. Nonetheless, this potential will only be realized if LDCs can overcome critical supply-side constraints to become competitive in international markets (section D).

Regional trade arrangements (RTAs)

One concern for LDCs is the proliferation and significance of regional trade arrangements (RTAs) in which trade and investment flows are becoming increasingly concentrated, despite the agreements reached under the Uruguay Round to strengthen the multilateral trading system. The growth of RTAs has accelerated, with new RTAs (such as NAFTA and MERCOSUR) being established, the membership of existing RTAs expanded (e.g. the enlargement of the EU), and formal links established between different RTAs. Most of the LDCs are themselves members, alongside other DCs, of RTAs in their own regions. But they are not included in RTAs, such as the EU and NAFTA, which encompass their major export markets in the industrialized countries. This has potentially important implications for the LDCs. These issues are discussed in greater detail in Part Two, chapter III: this section provides a brief summary of the implications of RTAs for the LDCs.

RTAs provide preferential market access to their own members, and hence discriminate against non-members. LDCs therefore stand to suffer a relative erosion of the terms of their market access to their major export markets because of the growth of RTAs covering these markets, with the associated danger that their exports will lose market share to competitors from within the RTA. The potential for such trade diversion, to the detriment of LDCs, can be minimized provided that RTAs adopt an outward-oriented trade policy towards the rest of the world and eschew protectionism. It is vital to the interests of LDCs, most of which are attempting to expand and diversify their exports, that RTAs maintain a liberal trading stance towards the rest of the world (i.e. do not raise protectionist barriers to non-members). LDCs, along with many other DCs, will be in an especially vulnerable position if competing trade blocs turn inward looking and erect protectionist barriers to non-members.

The LDCs are involved in a number of RTAs in their own regions, mainly in conjunction with other LDCs and DCs. Africa has a number of such RTAs, of which ECOWAS, COMESA and SADC are among the largest. Unfortunately, these RTAs have not so far proved effective in promoting intraregional trade flows for several reasons. There is usually only limited complementarity in the economic structures of the different country members (i.e. their production structures are very similar) and intraregional transport links are often poor. Moreover, in many cases governments have not actually implemented regional agreements to remove trade barriers to imports from fellow members, often because of domestic political opposition from industries which stand to lose from greater competition.

Despite these problems, RTAs would offer important advantages to LDCs if intraregional trade were effectively liberalized, not least because their own domestic markets are so small. Domestic firms would enjoy the benefits of the larger regional markets, allowing them to exploit economies of scale, while the increased competition would provide a stimulus to firms to raise efficiency. Regional markets could also act as a useful training ground for domestic firms with long-term ambitions to enter global markets. The larger regional market might also prove more attractive to both foreign and domestic investors than individual country markets.

D. Policy measures for maximizing the benefits of globalization and liberalization and reducing the risks entailed

The preceding sections have discussed the opportunities and potential dangers to LDCs arising from the current trends towards increased global integration and liberalization within the context of the UR of GATT. These trends provide important long-term opportunities for LDCs to increase their participation in world trade and their share of world incomes. The markets for LDC exports should expand as a result of anticipated increases in world trade in goods and services and the growth in incomes globally. Agricultural liberalization in DMEs, changes in consumer tastes, the opening-up of the markets of the former communist countries, and rapid growth in resource poor Asian countries, *inter alia*, should expand export markets for both the traditional primary commodities and non-traditional agricultural exports of LDCs. Hence, on the demand side of world export markets, prospects for the LDCs may be more promising in the medium term now than they have been for some time. Furthermore, rising wages in NIEs may induce firms engaged in labour-intensive export production, such as garment assembly, to relocate in low-wage LDCs.

Nonetheless, some aspects of the current course of global economic developments are not favourable for LDCs and threaten to accentuate their marginalization from the mainstream of the world economy. Their industries are exposed to stronger competition to which they lack the resources to respond effectively. The markets for their primary commodity exports are being further eroded through increased competition from non-LDC exporters and by the increased use of substitutes for raw materials. The concentration of private capital in Regional Trade Areas, which comprise of mostly the developed countries and the more dynamic DCs has intensified, with LDCs facing even greater difficulties in attracting FDI. The long-term opportunities of the UR notwithstanding, some of its agreements pose a number of potential problems for LDCs in the short term, including preference erosion, tariff escalation and higher food-import costs.

The fact that increased competition in global markets poses dangers for LDC economies reflects the very weak supply capacities in these countries. There is a lack of entrepreneurial and managerial skills, technological capacities are very poorly developed, the physical infrastructure is inadequate, the provision of support services, such as finance and marketing, is often very costly or unavailable, and labour productivity is low. The economic performance of most of the LDCs over the last two decades has been poor. With the exception of only about 10 to 12 countries (which have done reasonably well), the LDCs have suffered significant declines in per capita incomes, their share of world export markets has fallen, they have failed to diversify their exports away from the traditional primary commodities for which the external terms of trade have fallen, domestic food production has stagnated necessitating increased food imports, and they have attracted very little foreign investment. If LDCs are to derive any benefits from the opportunities emerging from the expansion of the global economy, major adjustments in economic policies, resource allocation, the structures of production and economic performance are essential. The primary burden of adjustment to the requirements of a liberalized global economy will inevitably have to be borne by the LDCs themselves.

Whether LDCs are able to exploit the opportunities and mitigate the dangers of increased global integration will be conditioned by the evolution of the process of globalization under the UR, but more significantly by the domestic policy responses of the LDCs. Globalization has boosted the premium on good economic policies and has exacerbated the repercussions of inappropriate policies, as evidenced by Mexico's financial crisis in late 1994. The increasingly competitive nature of the world economy has diminished the latitude that governments may have once had to pursue inappropriate policies, such as overvalued exchange rates, without inflicting serious damage on their economies. Globalization has important implications for the nature of economic policies in LDCs for two other reasons. First, direct controls by governments over economic activities within their own national boundaries (e.g. controls on capital movements) have become less effective and often increasingly counterproductive, as agents are more easily able to evade the impact of such controls. Secondly, because globalization has intensified competition on international markets, enhancing the competitiveness of production structures by improving productivity is essential. As a consequence, the focus of economic policies is increasingly shifting away from direct government intervention in markets and participation in production and trade, towards the creation of an enabling environment for the private sector and for the efficient operation of the market economy. The latter entails, *inter alia,* the maintenance of macroeconomic stability, the development of an appropriate legal and regulatory framework (to enforce contracts and protect property rights), and the efficient provision of public goods, such as education and health services, which cannot be supplied in an optimal manner by the market. In the LDCs, there is also a key role for governments, and their partners in the donor community, to play in facilitating the strengthening of supply-side capacities in the economy. Public investment and the provision of public goods, such as agricultural extension services, should play a complementary role to that of private investment in tackling impediments to the development of competitive industries in the LDCs.

The specific policy requirements of individual LDCs will differ, but it is possible to identify a number of key areas which policy should address in most LDCs. These include strengthening the export sectors through the rehabilitation of the existing primary commodity industries and the diversification of exports through the development of non-traditional export industries. Improving agricultural technology in order to enhance farm productivity and output is essential if economic growth is to be revived and living standards improved. Major efforts are also required to enhance human-resource development which is crucial to raising the productivity and competitiveness of the economy.

LDC adjustment efforts require intensified support from the international community. A crucial role for the international community will be to provide adequate levels of concessional finance to fund the infrastructural and social development programmes of LDC governments and technical assistance towards the enhancement of policy formulation capacity in LDCs. Of equal importance is the need to ensure that the exports of LDCs, or potential exports, do not face protectionist barriers in the importing countries. ◘

Notes

1 Alongside economic marginalization is the possibility that LDCs will also be marginalized politically: governments in DMEs may accord less consideration to the interests of LDCs (e.g. the distribution of official development assistance budgets) if the latter are perceived to be of diminishing economic importance in terms of trade and investment opportunities.

2 For example, there is a 32 per cent reduction - from 6.9 to 4.7 per cent - in the average tariff imposed on key non-oil industrial exports from a sample of 13 African LDCs to OECD markets as a result of the UR tariff cuts (calculated from the data in Onitiri, 1995, pp.69-79).

3 These figures are from UNCTAD, 1995b, annex table 1, pp.391-396; data in World Bank, 1995, p.12 show private capital flows to DCs rising further to $173 billion in 1994.

4 For example, the Standard Chartered Bank, which has been a major participant in retail banking markets in many of the Anglophone African LDCs since colonial times, has recently begun selling off or closing down branches in African countries as part of a global strategy to concentrate on corporate banking and the Asian markets.

5 Petroleum was excluded because among the LDCs it is an important export only for Angola.

6 The European Union, Japan, and the United States account for almost 60 per cent of the global imports of manufactures and more than two thirds of the world's exports of manufactures (World Bank, 1992, p.15).

7 Specifically for LDCs, a priori assessments on the overall impact of the UR are unlikely to produce definite results given the different trade patterns and configuration of their exports and imports, the sheer diversity of the LDC grouping and the wide range of issues covered by the UR.

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II. The Uruguay Round, Trade Diversification and the LDCs

A. Background

The Uruguay Round (UR) of multilateral trade negotiations, which was successfully concluded with the signing of the Final Act in April 1994, is by all reckoning an historic event. It was the longest trade negotiation ever to be undertaken, having been inaugurated in 1986, and it recorded the highest number of developing-country participants, who, to some extent, influenced its agenda.[1] Moreover, unlike the previous seven GATT rounds of negotiations, it had a broader agenda covering new areas such as services, intellectual property rights (IPRs) and investment measures, while setting out for the first time a programme for agricultural trade liberalization and the full integration of the trade in textiles and clothing within the GATT framework of rules.

Long before the UR was concluded, it was hailed by experts as a momentous event that would usher in a new phase in international economic and trade relations: a multilateral trading system capable of generating enormous welfare benefits for all countries -- developed, developing and the least developed -- which include the unprecedented growth of world trade and long-term efficiency gains. Despite the benefits suggested by some studies, it has also been noted that these will not be evenly distributed among countries. Indeed, the Ministers at the Marrakesh Ministerial Meeting acknowledged possible welfare losses for some poor African countries.

This chapter reviews the effects of the UR on LDCs;[2] in particular it examines the consequences the UR may have for the trade-diversification potential of LDCs. It also discusses the policy options available to LDCs in their attempts to maximize net benefits from the UR: how can LDCs cope with the difficulties that may arise from the implementation of the agreements and effectively utilize the opportunities?; what support measures can the international community provide to facilitate the adjustment and structural changes required in LDCs to enable them to withstand increasing competition in, and take advantage of the opportunities offered by, the new multilateral trading environment?

A discussion of this nature requires two caveats. First, there is still a lack of clarity on some issues that prevents an unambiguous statement of specific effects.[3] Nevertheless, it is very likely that, whatever the anticipated long-term gains, the UR entails transitional costs for poor countries, including LDCs. Secondly, given the different trade patterns and configuration of LDC exports and imports, the wide range of issues covered by the UR and the sheer diversity of the LDC grouping, any conclusion reached from an a priori assessment of its overall impact should be treated with some caution.

Main features of the Uruguay Round[4]

The key features of the Round include, first, the establishment of the World Trade Organization (WTO), to provide a common institutional framework for the conduct of trade relations among its members in respect of all the agreements and arrangements concluded under its auspices, including the entire results of the Uruguay Round. Secondly, tariffs on manufactures have been reduced on average by over one third. Thirdly, with the gradual phasing-out of the Multi-Fibre Arrangement (MFA) and voluntary export restraints (VERs), non-tariff measures (NTMs) have been rolled back to a considerable extent. Fourthly, an integrated dispute-settlement mechanism has been established, underpinned by more transparent and stronger rules, to apply to all multilateral trade agreements annexed to the Agreement establishing the WTO. Fifthly, the principle of differential and more favourable treatment has been built into the various agreements in recognition of the special developmental, financial and trade needs of developing countries and the least developed among them.

Specific features of the UR include the following:

Special and differential treatment

Special and differential (S and D) treatment for LDCs has been incorporated into the various provisions of the multilateral trade Agreements and in the "Decision on Measures in Favour of

Table 13: Summary of effects of some Uruguay Round Agreements on developing countries[a]

Main features of agreement	*Implications for developing countries*
1. *Agriculture:* Decisions in three areas limit agricultural policies: (i) export subsidies reduced; (ii) domestic support restrained; (iii) border measures "tariffied".	Improved access for agricultural exporters, but: (i) concerns over uneven product coverage (sugar, meats); (ii) agricultural net importers fear losses from higher prices.
2. *Textiles and apparel:* 10-year phase-out of MFA with elevated growth rates in quotas, sequential elimination of product coverage, but with temporary selective safeguards.	Potentially major gains to developing countries in area of prominent trade interest, but: (i) concern that adjustment in industrial countries concentrated in later years; (ii) concern over potential replacement by protective regime (anti-dumping); (iii) concerns of many countries that they will be uncompetitive against other suppliers and will lose.
3. *Tariffs and grey-area measures (VERs):* Tariffs to be cut a comparative percentage to Kennedy and Tokyo rounds. VERs measures to be phased out (specifics of how not yet clear).	Tariff cuts will improve developing-country access, but: (i) will likely be small in areas of special developing country interest (textiles and apparel); (ii) tariffs already low (except apparel) in most developed countries; (iii) African countries concerned over erosion of margin of preferences under the Lomé Convention.
4. *Services:* Broad principles agreed with sectoral exceptions and conditionality (MFN). Market access and national treatment embodied, with access commitments tabled.	Relatively few specific concessions tabled at this stage, which is more likely to prove the beginning of a process towards liberalization, rather than substantive liberalization in its own right.
5. *Intellectual property:* Establishment of broad international minimum standards of protection in the three areas of patents, trademarks, copyright. Disputes to be settled under the integrated dispute-settlement body under the WTO.	Many developing countries had already moved close to the minimum standards, in part due to prior bilateral pressures. Key issues are in the pharmaceutical sector.
6. *Dispute settlement:* Firm time limits over the stages of the dispute process, and the need for a consensus to reject a panel report strengthening the process.	Strengthened procedures in the interests of smaller countries bringing complaints against larger countries.
7. *WTO:* The world trade body established to give permanence to GATT. Two features are that: (i) countries acceding to WTO must accept all decisions in the Round package (unlike the Tokyo Round codes); (ii) acceding countries agree to be bound by an integrated dispute-settlement process covering the three areas of goods, services and investment.	Absence of menu choice in selecting which UR decisions to sign on to concerns some countries, as does the integrated dispute process. Some countries reportedly considered remaining as GATT Contracting Parties, rather than acceding to the WTO prior to the Marrakesh Ministerial Meeting.

Source: Hamilton and Whalley, 1995, pp.35-36.

a Implications for LDCs are the same as for developing countries, but LDCs may fare worse than them in some cases, as discussed in the text.

LDCs" annexed to the Final Act. In the latter Decision, it is stated, for example, that:

> "...if not already provided for in the instrument negotiated in the course of the Uruguay Round, notwithstanding their acceptance of these instruments, the least developed countries, and for so long as they remain in that category, while complying with the general rules set out in the aforesaid instruments, will only be required to undertake commitments and concessions to the extent consistent with their individual development, financial and trade needs or their administrative and institutional capabilities" (para.1);

> "The rules set out in the various agreements and instruments and the transitional provisions in the Uruguay Round should be applied in a flexible and supportive manner for the least developed countries...." (para.2 (iii));

> "agree to keep under review the least developed countries and to continue to seek the adoption of positive measures which facilitate the expansion of their trading opportunities." (para.3);

Agriculture

The UR aimed at achieving greater liberalization of international trade in agriculture, first by restricting the use of all direct and indirect subsidies to agriculture; secondly, by seeking reduction in export subsidies; and, thirdly, by reducing import barriers. Non-tariff measures (NTMs), including quantitative restrictions, are to be replaced with tariffs providing approximately the same level of protection. Tariffs resulting from this "tariffication" process, together with other tariffs on agricultural products,[5] are to be reduced by unweighted average of 36 per cent over six years (1995-2000), by the developed market economies (DMEs) and 24 per cent over 10 years (1995-2004), by developing countries (DCs). While LDCs are also required to tariffy NTMs and bind their tariffs, they are exempt from all reduction obligations applicable to other countries.

Textiles and clothing

The agreement in this sector is to progressively dismantle the quota system under the MFA and to fully integrate trade in textiles and clothing into GATT over a 10-year period starting from 1995. This is to be accompanied by increased growth rates in quotas and the gradual integration of products with recourse to a transitional safeguard for those products under restraint but not yet integrated into GATT.

TRIPs and TRIMs

The Agreement on trade-related aspects of intellectual property rights (TRIPs) creates minimum common international standards for the protection for patents, copyrights, trade marks, industrial designs, geographical indications, integrated circuits and undisclosed information (trade secrets) and extends patent protection to "processes" in addition to products. This increases current protection levels of intellectual property rights to fields of technology or areas not covered at present in LDCs. The Agreement on trade-related investment measures (TRIMs) clarifies and strengthens existing GATT rules in respect of trade-distorting or trade restrictive investment measures which are inconsistent with the GATT provisions on national treatment and on general elimination of quantitative restrictions.

Services

The General Agreement on Trade in Services (GATS) establishes a multilateral framework of principles and rules to govern global trade in commercial services. GATs has universal coverage and includes a comprehensive definition of trade in services covering four "modes of supply": supply through cross-border movement, movement of consumers, commercial presence and the presence of natural persons. It embodies commitments to general obligations by all WTO members which include, *inter alia,* the non-discriminatory application of the most-favoured-nation principle, transparency of measures affecting trade in services and increasing participation of developing countries in trade in services. While the general obligations apply to all services, obligations relating to market access and national treatment apply only to those services included in the national schedule of commitments allowing members to apply specific conditions. It provides a framework for progressive liberalization of trade in services in future negotiations.

Multilateral trade rules

These rules have been strengthened and made more transparent, particularly in the areas of dispute settlement, anti-dumping, subsidies, balance-of-payment provisions, customs valuation, rules of origin, etc.

World Trade Organization

The WTO is charged with strengthening the rule of law governing international trade, and ensuring its application through an effective dispute-settlement mechanism.

The main features of the UR and implications for DCs are summarized in table 13.

B. Possible implications

The available evidence (see, for example, GATT, 1994a; Page and Davenport, 1994; UNCTAD, 1994a; Weston, 1994, 1995; and the World Bank, 1995)[6] suggests that, in general, the global impact of the UR will be positive. The expected benefits include: a stable, secure and predictable trading system brought about by more transparent multilateral rules and disciplines and higher levels of tariff binding; higher global economic growth that will increase demand for DC and LDC commodity exports; and longer-term efficiency gains for DCs and LDCs due to competition engendered by increased liberalization.

The extent to which individual countries or different regions of the world share in these benefits will depend on their level of development defined by the pattern of, and participation in, international trade.

In the developing world, a group of Asian countries, notably the newly industrializing economies (NIEs), have emerged as the "growth pole" of the world and have rapidly altered their export baskets towards manufactures, as well as increased their participation in world trade. In contrast, the majority of DCs, in particular the LDCs, have seen their economic fortunes recede with increasing globalization and liberalization.

The share of LDC exports in world trade, which was about 0.7 per cent in 1975, has declined consistently since then. In 1992, only three LDCs, namely, Bangladesh, Botswana and Zambia, recorded exports above $1.0 billion (UNCTAD, 1995d, p.5).

LDC exports are biased towards primary commodities, mainly natural resource-based and tropical agricultural products which made up 70 per cent of their total exports in 1992, with manufactures accounting for 30 per cent. For DMEs, primary commodities accounted for 20 per cent of total exports, and manufactured goods for 80 per cent. The LDCs have lost substantial market shares in commodity trade over the past two decades: the value of LDCs' commodity exports in world-commodity trade decreased from 4.7 per cent (1970-1972) to 1.4 per cent (1990-1992) (UNCTAD, 1995e, table 3), *despite* the preferential treatment they enjoyed. Manufactured products, mainly garments, featured in the exports of a few LDCs: Bangladesh, Haiti, Lesotho and the Maldives (UNCTAD, 1995d, p.5). Even for these countries, the share of manufactured products in total exports exaggerate the value-added because of the high import content of such products.

Coupled with the above, LDCs are highly dependent on imports of not only capital goods, but also of food. Net imports of major food items (cereals, edible oils and dairy products) were equivalent to 25 per cent of the total export earnings of LDCs in 1992; and the share of food items in the total imports of 27 LDCs is above 20 per cent, higher than for any other group of countries (UNCTAD, 1995d, pp.5-6).

Evaluations of the impact of the UR within this context suggest that the new trading system it engenders entails transitional costs for LDCs, although the level and timing of such costs are in dispute. While much of the costs are estimated to be immediate, the benefits would accrue to the majority of LDCs in the long run, and, in part, depend on what policy adjustments are made by these countries in the short to medium run to improve their supply capabilities and efficiency of production in order to enhance their participation in world trade.

A number of studies suggests that the UR would result in substantial income gains for DMEs, in particular through a higher level of demand for textiles and agricultural products as restrictions are reduced (e.g. Hamilton and Whalley, 1995; Hoekman, 1989; UNCTAD, 1995d; Weston, 1995). Among DCs, the East Asian economies are expected to be net beneficiaries, while income losses are forecast for Africa and South Asia, and the prognosis for Latin America is ambiguous.[7]

Overall, the anticipated costs of the UR centre around three areas. First, preference erosion, that is the diminution of trade-preference margins following the reductions in MFN tariffs. Secondly, there is the possibility of higher prices for food, and other critical imports, like pharmaceuticals and technology because of the agreements on agriculture and TRIPs. Thirdly, costs are associated with compliance with notification requirements, policing the TRIPs agreement and increased participation in WTO activities.

Continuing the discussion, we first examine the likely implications of the UR for LDCs by discussing each of these issues. Secondly, we explore the effects the UR may have for the trade-diversification potential of LDCs.

Anticipated effects of the Uruguay Round on LDCs

Preference erosion

One major concern for LDCs, especially African LDCs, is the erosion of the margin of preferences they enjoyed under the generalized system of preferences (GSP) or Lomé Convention, and its ramification for their competitiveness.[8]

Regarding tropical agricultural and natural resource-based export items,[9] trade liberalization could entail some loss for LDCs in the short run. They are unlikely to benefit from the expected trade-creation effect, because of the low short-term supply elasticity of some of these products, e.g. tropical beverages; and they may suffer from trade diversion due to erosion of their existing preferential margins. However, in the long run, it may be possible for LDCs with an agricultural potential to increase foreign-exchange earnings by expanding agricultural exports.

Textiles and garments are of substantial export interest to one third of developing countries (GATT, 1993). The domestic value-added of these products is low because of a high import-content, but they have provided the impetus to industrialization in some LDCs. The sector is particularly important to Bangladesh, Cambodia, the Lao People's Democratic Republic, Lesotho and Nepal that face MFA and MFA-type restrictions in the Canadian and United States markets (and, in the case of Bangladesh, in the European Union (EU) market as well). Haiti also faces these restrictions in the United States market. To a minor extent, cotton yarn and fabrics feature in the export baskets of several African LDCs.

The phasing-out of the MFA and its associated tariff reductions, the provision for increased growth rates of MFA quotas and the improvement in the application of the flexibility provisions may expand, in the medium term, export opportunities for WTO-member LDCs -- Bangladesh, Haiti, the Maldives and Lesotho. Consequently, current market shares of non-WTO LDC members -- Cambodia, the Lao People's Democratic Republic and Nepal, may be threatened (UNCTAD, 1995d, p.11). Intensified competition in export markets may lead to a loss of market share by some LDCs to more developed DCs with stronger industrial bases, particularly in Asia (e.g. China, India, Indonesia, Pakistan and Sri Lanka) but also in Latin America. It is projected, for example, that Africa's apparel output will increase by only 30 per cent, instead of 110 per cent, barring any change in the MFA, over the 10-year period (Hertel, et al., 1995, pp.22-23, cited in Weston, 1995, p.10).

Competition may also increase among potential host countries for textiles and garment-related foreign investment and technology to the disadvantage of some LDCs that lack infrastructural and institutional preconditions critical for increasing FDI inflows.

On a trade-weighted basis, the overall loss of preference margins for all LDC products covered by preferences is about 8 percentage points for Canada, 3 points in the EU and Japan, and 2 points in the United States (UNCTAD, 1995d, p.9).[10] The extent of the loss of preference margins and its effects on the competitiveness of LDCs' exports depend on the rate of utilization of such preferences. If, as suggested by various UNCTAD studies, the rate of utilization of preferences was low (see section C for the reasons), then the effects of preference erosion on LDC exports would seem to have been exaggerated. The possible preference erosion for some LDCs under the Lomé Convention on agricultural products such as sugar, cut flowers, vegetables and fruits, and beef, may also be limited as the liberalization attained for these products and others, of export interest to some LDCs, is restricted under the agricultural agreement.

In summary, the UR holds the prospect for increased participation of LDCs in global trade provided that they can overcome critical supply-side constraints to become competitive in international markets (see below). First, there may be the potential for increased exports from LDCs as a result of higher world demand. Secondly, the binding of MFN-tariff reductions, and to a lesser extent, the tariffication of NTMs by making NTMs more transparent, may enhance LDC market access.

Table 14: Effects of the implementation of the Uruguay Round on world food prices by the year 2000

(Percentage change)

Commodity[a]	*FAO*[b]	*UNCTAD*[c]		*OECD/WB*[f]
		(1)[d]	*(2)*[e]	
Wheat	7.0	8.6	3.2	6.6
Rice	7.0	9.6	0.7	1.3
Maize	4.0	-	-	-
Millet/sorghum	4.0	-	-	-
Other grains	7.0	-	-	-
Coarse grains	-	9.0	2.9	3.3
Oil-seeds	-	7.7	3.8	-
Vegetable oils	-	5.9	2.5	4.6
Fats and oils	4.0	-	-	-
Beef	8.0	10.1	5.3	2.3
Pork	10.0	6.3	2.7	0.6[g]
Lamb	10.0	10.2	5.5	2.3
Poultry	8.0	9.3	4.9	0.6[g]
Dairy products	-	7.9	4.5	2.5
Milk	7.0	-	-	-
Sugar	-	11.3	4.5	3.0
Weighted average	**6.6**	**8.6**	**3.8**	**3.3**

Source: UNCTAD, 1995e, Add.1, table 11, p.15.

a The three institutions adopted slightly different definitions for commodities, e.g. FAO's "other grains" includes "coarse grains".

b FAO data taken form FAO document CCP:95/13, January 1995.

c Revised figures from UNCTAD, 1995f, which are different from those in the original source, UNCTAD, 1995e.

d UNCTAD column (1) assumes no price response in non-OECD countries to changes in world market prices.

e UNCTAD column (2) assumes a price response in non-OECD countries.

f OECD/World Bank's scenario allows for unemployment.

g Other meats.

Escalation in the prices of critical imports

For food items, studies have indicated that trade liberalization will inevitably result in higher world prices that will hurt food-deficit countries (e.g. some LDCs), while food-surplus countries (e.g. OECD countries) will gain. The possible negative impact of higher food prices for food-deficit countries was acknowledged by the Ministerial Decision at Marrakesh, but there was a dispute over the magnitude of price increases, and therefore losses to net food-importing countries.[11]

Countries with comparative advantage in agricultural production will gain in the long run from increased exports and better terms of trade. Cereals like wheat, rice and coarse grains for which protection and subsidies in the OECD countries were significant, are likely to cost more because of the possible effects of the three reduction commitments of the agricultural agreement on demand and supply: the quantity of these products "dumped" on the world market at subsidized prices will be reduced and DMEs' imports of these goods will increase (UNCTAD, 1995d, p.12).

FAO estimates indicate 11 per cent (or $0.5 billion) of the projected increase of $4.5 billion in the food-import bill of Africa between 1987-1989 and the year 2000 will be accounted for by the effects of the UR (Weston, 1995, p.16).[12] Projections by UNCTAD show that if the UR Agreement on agriculture is fully implemented, LDC overall trade deficits could worsen annually by between $300 and 600 million or by about 2.6 to 5.0 per cent of export earnings, amounting to $3 billion over a five-year period (UNCTAD, 1995d, p.14). For the effect of the UR on the food prices of selected commodities, see table 14.

Thus, the implication for LDCs of the UR agricultural agreement is the possibility of increases in their food-import bills which will impair their capacity to devote scarce resources to other areas of economic development.

Nevertheless, there are some uncertainties about the net effects of the agricultural agreement contained in the Final Act, especially as the effects will be partly dependent upon the pace of agricultural liberalization in the OECD countries.[13] There may be positive effects for LDCs if higher world food prices stimulate domestic production, and if enhanced market access to the OECD markets enables them to expand export earnings.

As food aid is exempt from export-subsidy cuts, there may be no short-term price increases for emergency food imports, although the long-term effect of this on the volume, and therefore price, of food aid is as yet uncertain, and depends, to a large extent, on policy responses in DMEs. If a fall in subsidies to commercial grain exporters induces a less than proportionate decline in total output, surplus food may continue to be directed to food-aid objectives to keep prices at, or near, pre-UR levels.

The TRIPs agreement may lead to increased costs for importing countries of pharmaceuticals, agrochemicals, technology, and possibly seeds in the short run. In the long run, high potential returns are possible on any transfer of technology attained in the process (UNCTAD, 1994a), in particular if greater protection increases the willingness of intellectual property suppliers to supply LDC markets.

Other effects

These include costs relating to compliance with notification requirements, legislative changes and the corresponding reorganization of institutional infrastructure, and the opportunity costs associated with the deployment of scarce managerial and administrative skills to WTO assignments, etc. These costs, and those relating to TRIPs and TRIMs, are not easily amenable to measurement, and hence are difficult to estimate.

The Uruguay Round and trade diversification

Apart from the specific effects, the UR may have some knock-on effects, not easily quantifiable, on the trade diversification potential and development prospects of LDCs.

Trade-diversification programmes and policies have been implemented in LDCs to attain three separate but interconnected objectives: earnings stabilization, export-revenue expansion and raising value-added. Stabilization of earnings and export-revenue expansion can be attained through horizontal diversification into commodities whose price fluctuations do not synchronize. Vertical diversification into higher value-added products, which entails processing domestic or imported inputs, may help a country increase value-added as well as improve its trade earnings. A fourth objective of diversification may be to reduce a country's dependence on a limited number of export markets (geographical diversification). This section briefly discusses the effects that the UR may have on LDC capability to attain these objectives.

Despite the trade restrictions entailed in the MFA, it did guarantee NIEs' exports minimum quotas in DMEs' markets, and provided them with a catalyst for growth. Relocation of firms from NIEs to Bangladesh and some other LDCs, in order to "jump" quota restrictions, provided a stimulus to the embryonic industrialization process of these countries. Quality upgrading within quantitative quota limits and diversion into non-quota markets have all contributed to product and geographical diversification (Trela, 1995).

The gradual phasing out of the MFA will reduce and finally eliminate quota rents enjoyed by some LDCs, although tariff preferences where they exist may offer competitive advantage in the short run. The ten-year transitional period may, however, offer the opportunity to undertake strategic restructuring and development of the textile industry through upgrading of design and production technologies in order to face the post-MFA global competition.

Nevertheless, if phasing out the MFA does indeed lead to free trade in the textiles and garment sector (i.e. if DMEs do not resort to anti-dumping and countervailing duties), it could be of a tremendous boost to industrialization in the more developed DCs (e.g. NIEs and second-tier NIEs).[14] To the extent that tariff reductions in this sector in the long run translate into enhanced access to DMEs' market for LDCs, and provided, as suggested above, the necessary restructuring is undertaken, the textiles and garment sector in these countries could be rejuvenated to increase export earnings as well as augment value-added.

At another level, tariff bindings contained in the UR, by setting maximum tariff levels, guarantee enhanced security in trading relationships which is conducive to long-term policy shifts such as those involved in trade-diversification programmes. The significant reduction in tariff escalation for many products in the major markets under the UR will provide a stimulus to LDC manufactured exports and enhance their diversification of production into higher value-added products (GATT, 1994c, p.9).

As argued by some analysts, GSP schemes may have implicitly encouraged commodity concentration and dampened pressures for more effective export-promotion policies (Weston, 1995, p.11). Thus, if they become less useful as instruments of managing trade due to possible preference erosion, pressure on LDC governments to engage actively in export promotion, including trade diversification, would intensify. Preference erosion could also expand and create new markets for LDC exports because a fall in MFN tariffs could erode advantages that DMEs grant each other, which would be to the advantage of LDC exporters (World Bank, 1995, p.38). Moreover, if the UR does lead to the reform of GSP schemes, this may stimulate reforms that could facilitate the diversification of both products and markets, in particular if the reforms increase product coverage and enhance access to the markets of all preference-giving countries (see below).[15]

If the agreement on TRIPs guarantees confidence and security in LDC markets for suppliers of technology and other intellectual property, the increased willingness to supply such markets should reduce current problems associated with transferring new technologies to LDCs. By improving the chances of technology transfer, TRIPs could facilitate vertical diversification and increase the value-added of LDC exports. The potential advantages associated with this in the long run should more than offset the anticipated increased prices of technology in the short run.

By reducing distortions in world prices, the agricultural agreement may yet create opportunities for horizontal diversification. LDCs with comparative advantage in agriculture may find it profitable to export food items that were unprofitable to export under the previous price regime.

Overall, to what extent a country benefits from the UR will be determined by the degree of external orientation in its trade policy. A country with an outward-oriented trade regime, which is conducive to trade diversification, stands a better chance of utilizing the opportunities inherent in the UR.

Nevertheless, the adjustment of LDC economies in the post-UR world will be plagued with some uncertainties. Although the Agreements on Subsidies and Countervailing Measures (ASCMs) and TRIMs provide for flexibility through transitional periods in complying with the obligations in respect, for example, of granting subsidies (in the case of ASCMs) or other incentives (in the case of TRIMs) mandatorily contingent upon the use of domestic over imported goods, it remains to be seen how this flexibility could be put into good effect within the allowed transitional period to have impact on domestic industrial capacity and trade diversification.

As yet, there are potential pitfalls, including the following, which create uncertainty and concern: contingency trade protection measures, transitional safeguard mechanisms, unless scrupulously and sparingly used, could undermine the UR's potential benefits for LDCs.

These notwithstanding, the greatest obstacles to the LDCs' attempt to diversify trade and/or readjust to a new post-UR trade environment are their structural weaknesses. To the extent that LDCs are able to overcome their constraints in technology, social (human capital formation) and physical infrastructure, they should be in a position to promote trade diversification, and enhance their development prospects by attracting new FDI to the textiles and garment and other sectors (see below). However, this is only feasible in the long run when they may begin to reap systemic benefits from the UR. The effects of the UR on developing countries are summarized in table 13.

C. Mitigating possible adverse effects of the Uruguay Round on LDCs

To the extent that the risk of LDCs being marginalized in a liberalized global economy is real, uncertainty over their gains from the multilateral trading system has increased. The need for reorienting their economies to meet the new challenges by becoming more competitive in the production of tradeable goods and services is paramount. While this has been acknowledged by LDC governments, supply-side factors have emerged as key impediments to LDCs' greater participation in international exchanges of goods and services on the one hand, and improving their access to foreign investments and technologies and know-how on the other.[16]

LDC economies are characterized by a variety of supply-side constraints or structural weaknesses which are a barrier to trade expansion and diversification (i.e. the expansion of both traditional primary products and non-traditional products and efficient import-substitution production). These constraints include: weak technological capacity, lack of entrepreneurial, managerial, marketing, and technical skills including those for quality control, paucity of long-term finance, expensive trade credit and pre-shipment finance, and non-transparent legal and regulatory framework. Deficiencies in the physical infrastructure are also major constraints in many countries, especially because of restraints on public-expenditure programmes.

In an attempt to adjust to the increasingly competitive international environment, most LDCs have, over the past decade, implemented policies to liberalize their economies under the banner of Structural Adjustment Programmes (SAPs) supported by conditional finance from the World Bank and the International Monetary Fund (IMF). These programmes have brought about some improvements in the macroeconomic environment, in particular macroeconomic stabilization in some LDCs, but policy measures to tackle supply-side constraints have remained limited, thereby retarding progress in this area.

The relative neglect of supply-side constraints is attributable to various factors: flaws in the design of reform programmes and continuing debate over the sequencing of different phases, lack of resources, both human and financial, the seemingly intractable nature of some of the constraints and lack of a consensus as to how they should be tackled. Analyses of countries undertaking adjustment have revealed that these issues are unlikely to be resolved in the foreseeable future as problems of underinvestment in human-resources development, weak private-sector response, and debt overhang, among others, persist in these countries. To date, the limited trade expansion and diversification attained by LDCs despite these efforts (Kirkpatrick and Weiss, 1995), underscore the fact that LDCs' ability to benefit from the multilateral trading system of the UR is predicated on their capability to produce traded goods and services competitively.

That there is a compelling case for external support measures to mitigate the possible adverse consequences on LDCs arising from the UR Agreement is widely recognized. DMEs stand to gain more from trade integration with DCs than from more integration among DMEs. Potential gains will arise from a more efficient utilization of resources, increased investment and innovation, higher productivity as well as increased market size, competition and technology spillovers (World Bank, 1995, p.3). However, external support measures need to be designed to correspond with domestic-policy responses. This is more so as the attainment of the trade diversification objective requires a delicate interplay of macroeconomic management and micro-level enterprise support measures, and the elimination of legal, regulatory and structural impediments for which external assistance is required.

National (domestic) measures

The overall objective of domestic policy should be a complete overhaul of economic management to enhance LDC participation in international trade. This will necessitate policy and structural transformations to meet the new challenges.

Policy measures should be directed at reorienting the incentive framework in favour of the tradeables sector, and at attaining improvements in the efficiency of production for domestic consumption (e.g. food) and external markets in order to meet increased competition from abroad.[17] This calls for a flexible production system, underscored by flexible product and labour markets, which is in consonance with trade-diversification objectives.

As part of the overall economic restructuring being implemented under SAPs, trade-policy reforms bolstered by sectoral and micro-level reforms are in progress in most LDCs. These reforms, in particular those that create an enabling environment for private enterprise, must be concluded and/or deepened.

LDCs' ability to compete in a liberal trade environment depends on a skilled, educated and flexible labour force capable of adapting and integrating new technologies into the production process. Thus, human capital development has to be tackled more systematically through increased investment in education, in particular, at the technical and/or vocational level, as the experience of NIEs has shown that investments in this type of training yield high returns. Regular on-the-job-training schemes can also help in updating skills of the workforce to enable them to cope with technological innovations. Training schemes oriented towards the provision of labour-intensive, long-distance services should enable LDCs to utilize their comparative advantage in the services sector which is one of the fastest-growing components of trade and FDI.[18]

To cope with the initial problem of high prices that may arise from the TRIPs agreement, LDCs must strengthen domestic administrative capacities to secure equivalent non-patented or off-patent products and procure technologies from competitive sources. More investment in research and development (R and D) by LDCs should help them in the long run to improve their technological capability and reduce the technological gap between them and the DMEs.

An efficient financial system that can provide long-term and risk finance, as well as trade and export credits, should be developed by implementing financial-sector reforms that encourage private-sector participation. Improved marketing channels in both domestic and export markets would enhance efficiency and facilitate increases in traditional as well as non-traditional exports. This should be accompanied by a more transparent legal and regulatory framework that is conducive to the development of efficient production structures.

The agricultural agreement gives some leeway to LDC governments to overcome some of their anticipated problems. Direct and indirect measures to encourage agriculture and rural development, including investment and input subsidies to low-income producers, are not outlawed. If properly targeted, such measures should be able to ease some of the initial difficulties of food-deficit LDCs, as well as to serve trade-diversification objectives. In the long run, sectoral policies should be strengthened to enhance food production by increasing the efficiency of agricultural production.

Generally, domestic policies should be designed and implemented in such a way as to ease supply-side constraints in order to facilitate the reallocation of resources by private agents into new lines of production (e.g. horizontal and vertical diversification) to boost and stabilize foreign-exchange earnings.

International support measures

One instrument for improving market access for LDC export items could be the provision of additional trade preferences, e.g. GSP. Other possible measures include supplementary financial and technical assistance from bilateral and multilateral sources to ameliorate supply-side constraints, improve the efficiency of domestic production, and provide market access and other trade- and investment-related support to enhance the supply capacity of tradeable goods and services in LDCs.

Generalized system of preferences (GSP)

As evident from the discussion in section B, the implementation of the Final Act entails the risk of erosion of tariff margins under existing GSP schemes. Nevertheless, new opportunities are likely to emerge for improving GSP coverage due to tariffication of agricultural products under the Final Act (see, for example, Davenport, 1994).

As pointed out by various UNCTAD studies,[19] the utilization of, and benefits derived from, GSP schemes by LDCs have been limited for a variety of reasons. Primarily, this is due to weak supply capabilities and limited product coverage in the schemes of those countries that are the main markets of LDCs, relatively restrictive rules of origin, as well as procedural and other complexities associated with the system, including frequent changes of the eligibility criteria of individual schemes. Inadequate institutional and managerial capacities in many LDCs also limit their ability to benefit from schemes that are applicable to their export baskets (see, for example, UNCTAD, 1993). Due to a more diversified export structure, the GSP benefited the more advanced DCs, mainly in South East Asia, and will probably not by itself provide a basis for sustaining and diversifying LDC exports without complementary reforms.

The primary objective of reforming GSP schemes should be to grant LDC exports enhanced access to DME markets and to facilitate the administration of the scheme to enable LDCs to increase the utilization rate and reap greater benefits from various schemes. To this end, a variety of measures could be implemented, including the following.

First, product coverage of the schemes could be extended to a wider range of export items. Similarly, reducing preferential rates to zero for most or all products, and removing all ceilings and/or quantitative restrictions, would enhance product coverage.

Secondly, measures such as the application of full and global cumulation, simplification of the rules of origin, administrative procedures and documentation, and the introduction of derogation rules[20] would improve the harmonization of interscheme diversity, thus facilitating the utilization of the GSP. If all preference-giving countries include goods originating from other beneficiaries in the calculation of local content, this will expand trading opportunities as well as enhance regional and south-south trade.[21] The review of GSP schemes should seek to introduce these improvements which will go a long way to offset the negative impact of the erosion of preferences enjoyed under GSP stemming from market access liberalization in the UR.

Financial and technical assistance

External assistance could be focused on short- and long-term issues. In the short term, net food-importing LDCs would require increased food aid and/or additional finance from donor countries and international financial institutions (IFIs) to cover anticipated increases in import bills.[22]

In general, assistance should be directed at the following areas: (i) removing obstacles (e.g. legislative, institutional, or personnel) that could frustrate LDCs' compliance with the UR Agreement and active participation in WTO activities; and (ii) identifying new trading opportunities based on existing export baskets of LDCs, e.g. to increase the level of utilization of preferential regimes such as GSP.

Debt-relief measures to alleviate the debt overhang of LDCs, such as debt rescheduling, and in particular the auction of debts on secondary markets, could also release scarce resources for domestic use in the short to medium term.

In the long run, external assistance should concentrate on expanding domestic food production in food-deficit countries, and on promoting trade diversification in order to utilize new trading opportunities. Donor support would be necessary to enhance the competitiveness of LDC economies by facilitating access to new technology, enhancing technological capabilities, and providing training programmes to improve local skills to support domestic diversification efforts. Assisting DCs, in particular LDCs, to adjust successfully to a post-UR world should be of interest to DMEs as well. The increasing integration of DCs benefits both them and the DMEs. A growing proportion of industrial-country exports goes to DCs: it was about one fifth in the late 1980s, is one quarter at present, and it is projected to exceed one third by the end of the next decade (World Bank, 1995, pp.1-2).

An adequate flow of external finance is particularly important because overcoming supply-side constraints in LDCs will require, in many cases, major investment programmes in physical infrastructure and social services. The private sector has a key role to play in LDC economies, but an expansion of public investment and social expenditure will be necessary to "crowd-in" private investment (Mosley, et al., 1992, and White, 1992, quoted in Kirkpatrick and Weiss, 1995). Given the low levels of incomes and savings in most LDCs, the resources needed for these investments exceed those that could be mobilized from the domestic economy, hence the need for external supplementary financial assistance. Inevitably, this will necessitate a reversal of the decline in aid flows to LDCs: since 1992 there has been a 7.9 per cent decline in aid flows to LDCs (OECD, 1994, quoted in Weston, 1995, p.22).

In deciding the level and timeliness of, eligibility for, and/or access to, external financial assistance, some pertinent issues need to be considered, including the following: Are existing financing facilities adequate to contain the additional financial needs stemming from the UR?[23] What should be the nature of a new financing facility specifically designed to promote post-UR adjustment in LDCs? Should such a facility have conditionalities or specific criteria to be satisfied by needy countries? What should be the criteria for deciding the level of assistance for each country? Should all LDCs have unencumbered access to this new financing facility?

At the subregional or regional level, neighbouring countries can also help to improve market access for LDCs within a framework of intraregional trade.[24] Alternatively, joining a regional trading bloc, for example the EU, may help LDCs to counteract the potential dangers posed by regionalism, such as a deterioration in market access. In addition to this "defensive reason", such an arrangement might entail some spin-offs for LDCs, including the "import" of useful institutions, and enhancing the credibility of trade reforms (Collier and Gunning, 1995, p.400).

D. Conclusions

Much of the prognosis about the effects of the UR is by no means certain as the lack of clarity on some issues prevents unambiguous conclusions of specific effects from being made. More importantly, globalization and liberalization seem to have a momentum that defies easy prediction. This section briefly flags some issues that may yet influence the UR's effect on LDCs. These include the trend towards regionalism, the decreasing commodity intensity of final goods, organization and implementation of external assistance, and systemic effects of the UR.

One major concern for multilateralism is the drive towards regionalism. Between 1948 and 1994, 109 regional trading blocs were notified to GATT. Ironically, one third of these were signed in the last half (1990-1994) of the UR negotiating process[25] (*The Economist*, p.27). If this proclivity for regionalism remains undiminished, the marginalization of LDCs could increase as most operate outside the major trading blocs or have asymmetrical and weak links with them.

The decreasing commodity intensity of final goods, an aspect of the technological revolution spurring globalization and liberalization, also has far-reaching implications for LDCs. While natural-resource endowments have become less significant in production, LDCs' commodity dependence is yet to diminish.[26]

By incorporating in the Final Act measures for technical and financial assistance for LDCs, the UR acknowledges the need for external assistance to enable LDCs to restructure their economies, but the modalities for delivering these are as yet unclear. This creates the necessity for additional research to work out how external assistance should be organized and implemented. More research and rigorous cost-benefit assessment is also required at the global level to determine with more certainty the specific requirements or assistance needed by LDCs, as a group, from bilateral and multilateral sources.

If systemic costs and benefits are incorporated into this sort of analysis, it should assist LDCs to cope better with the UR in order to reap its long-term benefits. This is particularly important, first, because most estimates seem to have concentrated on LDCs' loss/gain of export earnings and market shares to the neglect of the UR's multiplier effects. The UR's systemic effects, for example on employment in the agricultural sector (in which about two thirds of the populations of most LDCs are employed), have received little attention to date in UR impact analyses.

Secondly, the studies implicitly assume a counterfactual scenario of a continuation of the status quo *ex ante* if the UR had failed, which is unrealistic, as increased protectionism on the part of DMEs, a continuation of the unilateral liberalization by DCs, or some policy combination of these two were quite distinct possibilities. The counterfactual scenario, therefore, has to be explicitly and more realistically defined, taking into account not only the second round effects of the UR, but also the possibility of governments failing in their obligations during its implementation. Assumptions underlying studies have to be standardized and/or made more transparent to allow for replicability and more definite results. At the specific country level, further research may be required to:[27]

(i) estimate as accurately as possible the level of adjustment costs, e.g. to quantify net benefits or losses by analysing transitional and long-term costs as well as benefits;[28]

(ii) identify sector-specific obstacles to trade expansion and specify how these could be ameliorated;

(iii) explore ways of meeting the costs associated with the overall economic restructuring from domestic sources, and appraise the level and type of direct assistance required from bilateral and multilateral sources, for example, technical cooperation requirements for trade promotion and capacity building for trade-policy formulation and implementation;

(iv) design a country-specific programme of action for economic restructuring considering (i) to (iii) above.

The effects of the UR on LDCs must be monitored,[29] and measures must be put in place to deal rapidly with "unanticipated" responses. There is the possibility of new barriers being erected that could limit LDC trade expansion: e.g. escalation in the use of anti-dumping policies and countervailing duties, and abuse of the selective safeguard mechanism. Moreover, if the DMEs do not adhere to the special and differential treatment granted to LDCs in the Final Act (e.g. inability to provide technical assistance for agricultural development), their economic adjustment during the transitional period could be jeopardized. The resolution of outstanding "non-trade" issues, such as the relationship between the environment and labour standards on one hand, and trade on the other, could also deny LDCs the projected benefits of the UR.

Multilateralism in the post-UR world has enormous potential benefits for international trade and development, but the UR is not a rose without thorns: the S and D treatment granted to LDCs is a tacit acknowledgement of the transitional costs LDCs would incur in conforming to the UR Agreement. By creating an improved trading environment underscored by progressive liberalization in trade and capital markets, increasing competition and access to new technology, it threatens to push to the margin less competitive countries, in particular LDCs.

Most studies assessing the impact of the UR are in agreement on its short-run costs, albeit marginal, for the LDCs. Net losses are expected to be greatest for the least industrialized, commodity-dependent and poorest countries in Africa, most of which are LDCs. In the long run, LDCs should be able to diversify their trade and enhance their net welfare from a more liberalized trading environment if bilateral and multilateral assistance materializes to enable them to restructure their economies to adjust to increased competition and utilize emerging market opportunities.

If, as predicted by some studies, preference erosion results in net loss of foreign-exchange earnings, it could deny LDCs the opportunity to utilize scarce domestic resources to finance the economic restructuring necessitated by the UR in the short run. Phasing out the MFA is likely to dampen incentives for LDCs to diversify vertically into higher value-added products in the short run, as they may be crowded out by the more developed DCs already established in such markets, but it should improve market access in the *long run* for some LDCs, including perhaps those denied access under the MFA regime.

LDCs are likely to derive major benefits as result of the impact of the UR in other areas of trade. First, reductions in tariff escalation in the major markets will enhance the production of manufactured exports in LDCs. Secondly, the dispute-settlement mechanism, substantially strengthened in favour of smaller countries under the UR, should be seen as of significant benefit to LDCs. Indeed, it should make it easier for them to assert their rights under GATT. Thirdly, although the agreement on agriculture may entail short-run costs for net food-importing countries, with the reduction in agricultural export subsidies in OECD countries, LDCs as a group should be able to increase their exports of agricultural products to the developed countries in the long run if they can overcome critical supply-side constraints.

Generally, given most LDCs' structural weaknesses that render their agricultural and industrial production inflexible and uncompetitive, this group of countries is unlikely to withstand unbridled competition in the post-UR era. In the short run, DMEs stand to increase their share of the world market for goods and services to a greater extent than the DCs, in particular the LDCs. In the long run, if LDCs make good progress in reducing supply-side constraints, the consequent trade expansion, particularly the enhanced production of non-traditional exports, should help them attain trade diversification objectives: that is, diversify markets, and products and/or increase value-added content, and improve earnings stability.

Overall, the impact of the UR on LDCs depends on numerous intervening variables. Any a priori assessment is therefore, of necessity, rendered somewhat impressionistic. Nevertheless, to the extent that the UR promises an era of free trade in an increasingly globalized and liberalized environment, it does offer some opportunities, albeit limited, to LDCs, the exploitation of which depends on country-specific characteristics, as well as on the level of bilateral and multilateral assistance available to each country and to the LDCs as a group. Most importantly, the gains of LDCs depend on their own trade regimes and how Articles in the Final Act on the special and differential treatment of LDCs are interpreted and implemented.◘

NOTES

1 Technical assistance provided by UNCTAD and UNDP to developing-country teams was crucial in this respect.

2 The effects of the UR on DCs (and LDCs) have been the subject of numerous UNCTAD studies, for example: Trela, 1995; UNCTAD, 1990, 1991, 1994c and 1995a-f. See also UNCTAD, 1995e, for a selected bibliography on this by UNCTAD and other international bodies.

3 A "cause and effect" analysis is also problematic for some issues like erosion of preferences that may result from the UR, as it implicitly assumes a continuance of the *status quo ex ante*, which is doubtful in a post-UR world.

4 See for example GATT, 1994b, 1995, and UNCTAD, 1994a.

5 This excludes some major agricultural products or food of special interest to DCs, in particular, fish and fish products, forestry products, jute and hard fibres and their products and natural rubber, which together with minerals and metals are treated as belonging to the industrial sector (UNCTAD, 1995e, p.9).

6 Much of this evidence is derived from analysis of old data on different products at the aggregate level using partial equilibrium models.

7 The estimates of costs and benefits for the various regions differ depending on the model used, the assumptions underlying it and the base and end years selected (see Weston, 1995, p.6, for some specific estimates). There is, however, a consensus that losses may be greatest for the poorest countries, especially in the short run, and the largest gains may accrue to the DMEs followed by the middle-income countries and the NIEs. One model suggests that only 11 per cent of the global annual gains of about $70 billion will accrue to developing countries (see Hamilton and Whalley, 1995, p.34; and their end notes 5 and 6).

8 Some studies are, however, sceptical about the adverse impact of preference erosion (for some examples, see Weston, 1995, pp.7-9). For a detailed analysis on the market- access implications of the Final Act for LDCs, see UNCTAD, 1992, chap.V.

9 This excludes non-agricultural exports, for example minerals, which are practically duty-free, even for those with MFN status. On the basis of this, some experts have argued that loss of preferences for such exports to the EU will make ‘no real’ difference for Africa as these make up more than half of its total exports (see Hamilton and Whalley, 1995, p.41, and Weston, 1995, p.8).

10 Generally, losses are estimated to be less than 5 per cent of total export earnings, and more than 10 to 20 per cent of export earnings in only a few cases (UNCTAD, 1995a). Estimates of losses likely to result from loss of EU preferences in 1989 are as low as 0.5 per cent of total African exports and less than 0.3 per cent of sub-Saharan Africa’s exports in 1992 (for the loss of OECD preferences). It is also argued that the full impact of changes will be gradual as tariff cuts for other suppliers (most favoured nations (MFN)) will be phased in over 6 years (Weston, 1995, p.7).

11 Indeed, there is some scepticism about the adverse effects of the Final Act on agricultural policies on world prices and food-aid surpluses for two reasons. First, the agricultural policy changes agreed are not as wide ranging as was anticipated; and secondly, some of the observed changes in world prices will reflect ongoing agricultural liberalization policies in DMEs rather than the effects of the UR (Page and Davenport, 1994, p.34).

12 Although some estimates suggest a net positive effect on SSA’s agricultural trade balance as exports expand more than imports (DeRosa, 1994, p.11, cited in Weston, 1995, p.16), this is more likely to be so for middle-income rather than low-income countries (Weston, 1995, p.16).

13 It should be noted in this connection that studies that have assessed the quantitative impact of the UR Agreement on commodities since the conclusion of the Round have reported more modest results than earlier ones (see UNCTAD, 1995e, for a survey of the studies; Part Two reviews the impact of the UR Agreement on specific agricultural commodities covered by it).

14 The pessimism this entails for LDCs is tempered to some extent by the fact that NIEs face high costs of production (e.g. labour costs) at home, and thus may continue to shift production facilities to LDCs; in particular, LDCs with technological, physical and social infrastructure stand to gain. Thus NIEs may lose some market share to some LDCs.

15 DCs in Latin America and Asia witnessed significant improvements over the last two decades in diversifying their export markets by reducing the value of commodity exports to DMEs from 80 and 60 per cent between 1970 and 1972 to about 69 and 50 per cent, respectively; but the value of commodity exports of African DCs (about two thirds of which are LDCs) to the DMEs had remained constant at about 76 per cent over the same period, with the EU’s share increasing by seven percentage points to 58 per cent (UNCTAD, 1995e, Add.1, table 2) probably because of the Lomé Convention.

16 Recent studies on African industrialization have, for example, exposed its weak technological capacity in terms of the ability to apply, adapt and

modify new technology in the process of industrial production (see Lall, 1993, and Park, 1993, cited in Kirkpatrick and Weiss, 1995).

17 The need to produce even primary exports more efficiently has become urgent given the declining shares of LDC exporters in world markets due, in part, to product innovation in DMEs and more efficient production and marketing of competing goods and services in more developed developing economies.

18 It is estimated that this alone could potentially double developing countries' commercial service exports, currently estimated at about $180 billion (see World Bank, 1995, p.3).

19 For example, one such study showed that the utilization rate of GSP schemes (i.e. ratio of imports that actually received preferential treatment to covered imports) of OECD countries fell by 2.6 per cent in 1992 to 46.9 per cent in 1993. However, the value of total developing-country imports actually receiving preferences increased from $64.1 billion in 1991 to $79.0 billion in 1993. This could be explained by one characteristic of the schemes: quota restrictions are based on quantity (e.g. weight, number of items) and not value based (i.e. worth of products).

20 These rules provide that appeals for preferential treatment, on a product and country basis, should be addressed within a limited period, e.g. three months, failing which the preference must be granted. Similar rules are already applied to African, Caribbean and Pacific (ACP) countries under the Lomé Convention.

21 Regional cumulation is granted by the EU to some regional groupings, e.g. ASEAN, Andean Group and the Central American Common Market (CACM); Japan and the United States also operate similar but slightly different systems (Inama, 1995, pp.97-108).

22 This is also part of the recommendations of the Marrakesh Ministerial Decision.

23 It is doubtful if the existing facilities of the World Bank and the IMF would be adequate, in particular considering the conditionality attached to these facilities and some of the issues raised below.

24 This may not be entirely in consonance with a post-UR multilateral trade environment, but it could well be one way LDCs respond to the increasing trend towards regionalism. Moreover, two major problems that have increased the potential trade diversion effects and limited potential trade creation effects of such a trade would, however, have to be overcome first: high regional transportation costs and inefficient manufacturing activities (Kirkpatrick and Weiss, 1995).

25 It is not clear how much of the interest in trading blocs was due, at the time, to the increased pessimism of the UR's successful conclusion. What is evident is that the drive towards regionalism is yet to diminish as more ambitious plans are on the horizon for extending old ones (e.g. NAFTA and others in the Latin American and Caribbean region into Free Trade Areas of the Americas), and creating new ones (e.g. South Asian Preferential Trade Area to be set up by the seven-member ASEAN group by the year 2003).

26 See section B for a detailed discussion of the reasons underlying the trends in world commodity markets and how these could affect LDCs.

27 Canada and Switzerland have already led the way by commissioning studies to determine the impact of the UR on selected aid recipients. But, as cautioned by Weston (1995, p.22), such studies need to be coordinated to avoid duplication.

28 This is particularly important as it has been argued that the tendency to put too much emphasis on analysing aggregate effects at the expense of individual country analysis, product experience or possible future changes in production structures, underscores the estimated marginal losses attributable to preference erosion by many studies for developing countries, thereby weakening the case for compensation for their loss (Weston, 1995, p.7).

29 The need for monitoring is recognized in the Final Act as stated in the Decisions on Measures in Favour of LDCs: expeditious implementation of all special and differential measures taken in favour of LLDCs [LDCs] is to be ensured through, *inter alia*, regular reviews (para.2 (i)).

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III. Regional Trading Arrangements and LDCs

A. Introduction

Despite the strengthening of the multilateral trading system through GATT/WTO, regional trading arrangements (RTAs)[1] have assumed even greater importance in recent years. RTAs are growing in number (i.e. new ones are being established), they are expanding (adding new members) and there are tentative moves to link them together. Most of the major RTAs (North American Free Trade Agreement (NAFTA), the European Union (EU) and the Association of South-East Asian Nations (ASEAN)), which have created a large economic bloc or space, do not include LDCs, and are unlikely to do so in the foreseeable future, although some RTAs have established formal trading links with developing country (DC) groups which provide the latter with preferential access. (The most important of these for the LDCs is the African, Caribbean and Pacific (Group of States) (ACP) which is linked to the EU through the Lomé Convention). LDCs are members of regional developing country RTAs (DC RTAs), but most of these have not proved effective in boosting trade flows and other economic exchanges between their members. A second group of DC RTAs, which consists of only DCs (i.e. excludes LDCs, e.g. MERCOSUR, Central American Common Market (CACM)), can also be identified. This group is not discussed here because LDCs' external trade with them is negligible or non-existent.

Currently, attitudes towards RTAs seem to be dictated by issues that transcend trade and cover technology, money and finance, within the wider context of the process of integration of the global economy (globalization). RTAs are increasingly being regarded as capable of providing opportunities far beyond the liberalization possible within the context of the Uruguay Round. This is witnessed by the concern of the second wave of integration (i.e. old and expanding, new and proposed RTAs) with new issues such as investment, services and technology and environment policies. Private-sector interest in enhancing market access and in strengthening investment opportunities has provided a further impetus to the search for new trading arrangements and enlargement of old ones (Ricupero, 1996).

Within this context, RTAs present LDCs with two sets of issues that impinge in significant ways on their development prospects. First, what are the implications for the LDCs of the strengthening of existing RTAs of which they are not members, i.e. the large economic blocs referred to above, such as NAFTA?; will LDCs face a reduction of access to the markets of these RTAs?; does this involve the loss of preferences for LDCs *vis-à-vis* third countries?; and how can LDCs' interests best be secured? This issue is discussed in section B.

Secondly, should LDCs place greater emphasis on economic integration with their regional DC partners through DC RTAs? What are the potential costs and benefits of regional integration for the LDCs? Can regional integration provide a substitute for global trading links or can it play a complementary role for the LDCs? This issue is considered in the latter part of section B. LDCs have already had extensive involvement in a variety of RTAs in the developing world. Section C assesses whether DC RTAs with LDC members have achieved their objectives, what the constraints and problems have been in strengthening regional economic integration through DC RTAs, and what lessons can be drawn from these. The conclusion examines briefly the implications of the growth of RTAs for LDCs in a global economy.

B. Implications of RTAs for LDCs

RTAs of which LDCs are not members

In the last two to three years, there has been rapid progress towards regional integration in many parts of the world. Notable aspects of this progress include: first, the NAFTA agreement, secondly the enlargement of the EU, and thirdly, the strengthening of the EU's trade relations with Eastern European countries. There are ambitious plans to enlarge, deepen and link existing RTAs. These include the eventual entry of Eastern European countries into the EU, proposed trade links between the EU and Southern Cone Common Market (in Latin America) and the EU and the Mediterranean countries, the extension of NAFTA to additional countries in Latin America (to create a Free Trade Area for the Americas) and the target set by the Asia-Pacific Economic Cooperation (APEC) countries for free trade and investment in the Asia-Pacific region by 2010-2020 (UNCTAD, 1995).

LDCs cannot be indifferent to the growth of RTAs given that RTAs of which they are not members now cover virtually all their major export markets, including Europe and North America. The main impact of the growth of the RTAs will be on trade, investment and technology transfer. The creation of an RTA implies, by definition, that members receive preferential access to each others' markets *vis-à-vis* non-members: hence, non-members must suffer a relative erosion of market access. How important such an erosion would be for specific non-members, such as LDCs, depends upon a number of complex factors.

The creation (or expansion or deepening) of an RTA may have trade-creating and/or trade-diverting effects: the former would provide potential benefits for non-members by stimulating demand for their exports, while the latter would have costs.

Trade diversion will occur when the lowering of trade barriers within the RTA, relative to those imposed on imports from outside the RTA, leads to RTA importers substituting products originating within the RTA for those produced by non-members: i.e. third country exports lose their markets within the RTA because of the preferential access granted to RTA exporters. Trade diversion is more likely if there is a degree of complementarity between members of the RTA (i.e. different members produce different goods and services). Recent trends in RTAs have included the integration of advanced industrial economies with developing and transitional economies (e.g. the linkage between the United States and Mexico in NAFTA and that between the EU and Eastern European countries): this is likely to increase the degree of complementarity in the production structures of RTAs and thus the dangers of trade diversion from non-members (Page, 1995, p.28). The degree of trade diversion will be lower when the RTA is more open towards imports from the rest of the world (and therefore the level of trade preferences enjoyed by producers within the RTA will be lower). If trade-diversion effects are significant, it is likely that this will also influence the allocation of investment: i.e. investment will be attracted to RTA members at the expense of non-members (see below for further discussion of "trade creation" and "trade diversion").

The potential dangers of the growth of RTAs for the LDCs arise therefore from the possibility that their export markets in the RTAs (or in the prospective new members of these RTAs) will be lost to producers within these RTAs, because the latter have gained trade preferences in RTA markets relative to LDC exporters. However, it is possible that the actual diversion effects will be small for two reasons. First, LDCs produce few export products that directly compete with products exported by RTA members, largely because the latter have much more developed production structures than do LDCs (the garment exports of Bangladesh and some other LDCs, and various agricultural products, such as sugar, are possible exceptions). Secondly, the agreement reached under the Uruguay Round to bind tariff levels together with other obligations may ensure that RTAs maintain an outward-oriented approach to trade policy, i.e. do not raise levels of protection towards non-members.[2]

Moreover, the growth of RTAs may also have potential advantages for LDCs. If regional integration stimulates faster economic growth in the major export markets, the LDCs may benefit from an expansion of demand for their main export commodities. LDCs might also benefit if an existing RTA with which they have preferential trading links (e.g. the EU for LDC members of the ACP group) is expanded, because they would gain preferential market access to more countries, although they would lose preferences *vis-à-vis* the new members in the markets of the existing members.

RTAs could become a potential threat to multilateral trade liberalization, although this need not necessarily be the case provided that they maintain an outward-oriented approach to trade policy. If the world were to be divided into competing trade blocs, each adopting protectionist policies towards non-members, the weaker DCs, particularly the LDCs, would be among the worst to suffer. LDCs, in particular, therefore have a strong interest in ensuring that regionalism does not degenerate into protectionism but is instead carried out in a manner which is complementary to multilateral trade liberalization. At the same time, they need to ensure that regionalism does not exclude them either by design or by default. The interests of LDCs can be accommodated by the RTAs, provided that the latter are sensitive to the trading and developmental requirements of LDCs and do not pursue policies that have adverse affects on the LDCs. In particular, it is imperative that RTAs do not expand the range of "sensitive" imports from non-members that are subject to protectionist trade barriers (many of the imports deemed "sensitive", such as textiles or agricultural products, are exported, or are potentially exportable, by LDCs). RTAs could go a long way towards ensuring that the trading interests of LDCs are not damaged by guaranteeing the LDCs the same terms of market access as that enjoyed by RTA members themselves (including access for sensitive imports), possibly by establishing association accords with DC that include LDCs, in a similar manner to that which existed between the EU and European Free Trade Association countries (Collier and Gunning, 1995, pp.403-406).

RTAs with LDC members

The developing world displays a wide variety of, often overlapping, regional integration schemes. The African continent features more than 50 per cent of these RTAs, many of which are moribund (table 15).

RTAs are formed with the objective of stimulating trade among prospective members through liberalization of intraregional trade barriers. The issue of benefits and costs of RTAs is, however, a complex one which is not readily amenable to empirical evaluation. While it is possible to discuss the conditions under which RTAs can be beneficial or costly to members, drawing firm conclusions from this is problematic. The costs and benefits of an RTA for its members can be analysed from the static, dynamic, institutional and distributional perspectives.

Static effects

According to Viner (1950), we can distinguish between two possible effects of the economic integration involved in RTAs: "trade creation" and "trade diversion". Trade creation (which is welfare-enhancing) occurs where higher-cost domestically produced goods of member countries are substituted for by the imports of lower-cost goods from other members of the RTA. There is trade diversion (which is welfare-reducing) when higher-cost imports from members of the RTA are substituted for lower-cost imports from third parties (Joshua, 1989, p.64). Whether DC RTAs have, on the average, a net trade-creating or trade-diverting effect depends in part on the economic and trade structures under which they operate.

Trade creation is more likely under the following conditions: (i) the existing external trade of potential members is small relative to their domestic production; (ii) a high proportion of external trade is already with prospective members; (iii) there is a high relative price differential of protected manufactured products; (iv) there are high pre-integration tariffs on products from outside the prospective union (Robson, 1987, p.22).

Few RTAs involving DCs and LDCs, with the possible exception of East Asian DCs, exhibit these conditions. Hence, the static benefits of RTAs for these groups of countries, in terms of trade creation, are likely to be limited.

Dynamic effects

The potential benefits of RTAs for LDCs are likely to manifest themselves more within a dynamic framework. The creation of an RTA may facilitate the growth of more efficient and competitive production structures as a result of the impact of economies of scale and greater competition.

RTAs may lead to larger regional markets which may create opportunities for LDC firms to exploit economies of scale and thus improve efficiency. Many manufacturing firms in LDCs operate at a fraction of their potential capacity, often because the domestic market is too small. The liberalization of regional barriers will provide these firms with guaranteed access to much larger markets and therefore the opportunity to increase capacity utilization which would, in turn, assist them to raise production efficiency. The larger markets may also be more attractive to both domestic investment and to foreign direct investment (FDI) than the smaller markets of individual LDCs. In particular, RTAs in Asia may benefit from FDI emanating from the newly industrializing economies of South and South East Asia, while those in Africa may be attractive to South African FDI.

Greater competition in domestic markets may stimulate efficiency improvements by LDC firms and may provide a useful training ground for those firms to raise productivity and quality to international standards so that they can eventually compete on global export markets. The increased flow of FDI to RTAs may enhance the access of LDC firms to technology, entrepreneurship and market information, all of which will be important in facilitating their entry into international markets.

Distributional effects

The benefits of regional integration are unlikely to be equally distributed across all members of an RTA. Those LDCs whose import-substituting industries cannot compete with those of the more industrially advanced RTA members (such as South Africa or India) may experience de-industrialization and loss of employment. FDI might also be concentrated in the latter countries because of their more developed infrastructural base resulting in polarization within the RTAs. It has been argued that the experience with RTAs in Africa (e.g. the West African Economic Community and the now-defunct East African Community[3] and other parts of the developing world (e.g. the Central American Common Market in Latin America) demonstrates that the location of new economic activities, in a free economic environment, is skewed in favour of the more advanced members of RTAs where these members are at different stages of economic development (Robson, 1987, pp.201-202; see also UNCTAD, 1973, 1975).

A further issue of concern for LDCs is the possible loss of tariff revenue if regional tariff rates are reduced. The actual or potential loss of both economic activity and revenue from import duties are normally issues that generate strong concerns, in particular among the relatively weaker countries (Joshua, 1989, p.63).

Some of these issues, e.g. revenue loss, could be resolved in the short term. The corrective mechanism commonly used for reducing the effects of revenue loss is fiscal compensation.[4] This involves a budgetary transfer from a net-exporting member country to a net-importing member country based on the amount of tariff revenue foregone as a result of importing products under preferential tariff conditions (Robson, 1987, pp.202-203; Joshua, 1989, p.64).

Institutional benefits

Table 15: Major African DC RTAs of which LDCs are members

RTAs[a]	*Total membership*	*LDC members (total)*
UDEAC	6	Central African Republic, Chad, Equatorial Guinea (*3*).
CEEAC	10	Burundi, Central African Republic, Chad, Equatorial Guinea, Rwanda, Sao Tome and Principe, Zaire (*7*).
ECOWAS	16	Benin, Burkina Faso, Cape Verde, Gambia, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Sierra Leone, Togo (*12*).
COMESA	23	Angola, Burundi, Comoros, Djibouti, Ethiopia, Eritrea, Lesotho, Madagascar, Malawi, Mozambique, Rwanda, Somalia, Sudan, Uganda, United Republic of Tanzania, Zaire, Zambia (*17*).
CEAO	6	Benin, Burkina Faso, Mali, Mauritania, Niger (*5*).
SADC	11	Angola, Lesotho, Malawi, Mozambique, United Republic of Tanzania, Zambia *(6*).
EAC	3	Uganda, United Republic of Tanzania (*2*)

Source: UNCTAD database and Joshua, 1989, table 1, pp.61-62.

a In addition to the RTAs listed, there are other numerous groupings in Africa mostly concerned with development, for example, of river basins, on a cooperative basis.

UDEAC: Central African Customs and Economic Union (founded in 1966, revised in 1975).
CEEAC: Economic Community of Central African States (founded in 1983).
ECOWAS: Economic Community of West African States (founded in 1975).
COMESA: Common Market for East and Southern African States (formerly the Eastern and Southern Africa Preferential Trade Area founded in 1981; renamed COMESA in 1993, but excludes South Africa).
CEAO: West African Economic Community (founded in 1973, but dates as far back as 1959).
SADC: Southern African Development Community (founded in 1980).
EAC: East African Community (defunct).

Aside from direct benefits related to enhanced trade flows, the participation of LDCs in DC RTAs may bring about several other important advantages for LDCs (Collier and Gunning, 1995). Policy-making is generally difficult in LDCs and policies often lack credibility (i.e. agents may not be convinced that governments will not reverse reforms). This is partly because of political instability and partly because many of the reforms are a response to the conditionality attached to external financing.

Trade liberalization is especially vulnerable to domestic political pressure for policy reversal (i.e. a reimposition of trade barriers) because the losers (urban workers and industrialists in protected import-substituting industries) are often a politically important constituency. Even if governments resist pressures to reverse trade liberalization, lack of credibility has important costs for the economy because it deters investment. Hence, an institutional arrangement that binds a government to particular policy reforms, such as the removal of trade barriers, can enhance the credibility of these reforms. An RTA can play a useful role in this regard because a government cannot reverse the liberalization of barriers to imports from fellow members of the RTA without breaking its agreements with these countries. Moreover, the reciprocal agreements reached under an RTA may make trade liberalization more acceptable politically if governments can argue that they will gain improved access to other countries' markets in return for liberalizing their own.

RTAs may also have an "insurance policy" effect: DC RTAs could be useful as an institutional vehicle for bargaining with other RTAs (such as the EU and NAFTA) in order to secure enhanced access to the markets of the latter. This might help to ensure that the LDC exports deemed "sensitive" in the industrialized countries would not be subject to protectionist restrictions, such as safeguard and anti-dumping measures, and prevent the LDCs from becoming marginalized from preferential trading arrangements centred around the major industrial country trade blocs. DC RTAs are also likely to strengthen significantly the bargaining position of LDCs *vis-à-vis* transnational corporations. Indeed, for LDCs, the prospective benefits of regional integration schemes may derive from non-trade areas rather than from trade.

C. LDCs' Experience with RTAs

LDCs, especially those in Africa, have been, and are, involved in numerous RTAs, comprised of DCs in their own regions, of which the membership of many overlap. Among the most prominent of these RTAs are the Economic Community of West African States (ECOWAS), the Common Market for Eastern and Southern African States (COMESA, formerly the Preferential Trade Area for Eastern and Southern African States (PTA)), and the Southern African Development Community (SADC).[5] ECOWAS was formed in 1975, the PTA in 1981 and SADC in 1980. Other RTAs in Africa include those encompassing members of the Communauté financière africaine (CFA) franc monetary zones (see table 15 for LDC membership of major African RTAs).

The major DC RTAs in Asia and the Pacific include the South Asian Association for Regional Cooperation (SAARC) and the South Pacific Forum (SPF). The only LDC in the Western Hemisphere, Haiti, has an observer status within the Caribbean Community.

The general experience of DC RTAs has been disappointing in terms of the levels of intraregional trade generated by these arrangements. The exports of the LDC members of each of the three major African RTAs (COMESA, ECOWAS and SADC) to their fellow RTA members as a proportion of their total exports to the world declined over 1980-1990. ECOWAS recorded the largest decline of about 7 percentage points, followed by SADC of almost 3 percentage points, and COMESA by 2.5 percentage points (table 16).

There are many reasons why African RTAs have not been effective in stimulating greater intraregional trade. The economic structures of LDCs often militate against trade with other DCs: production structures are weak and there are no intersectoral and intercountry linkages (Onitiri, 1995, p.43). Most LDC exports are primary commodities for which regional demand is very limited, while many of their import needs, such as fuel and manufactured goods, cannot realistically be met by their RTA part-

Table 16: African LDC exports to regional partners and the world
(Millions of dollars)

From	*To*		
	COMESA (1)	*World* (2)	*Share (%)* (1)/(2)
COMESA[a] (LDCs)			
1980	321.9	5419.9	5.94
1990	293.5	8527.4	3.44
1994	284.9	8045.0	3.54
ECOWAS[b] (LDCs)	*ECOWAS*		
1980	227.4	2039.6	11.15
1990	170.8	4448.8	3.84
1994	175.8	2922.2	6.02
SADC[c] (LDCs)	*SADC*		
1980	96.0	2104.6	4.56
1990	95.8	5399.4	1.77
1994	186.9	4732.6	3.95

Source: UNCTAD secretariat, based on IMF, *Direction of Trade Statistics, 1995*.
a COMESA, Common Market for Eastern and Southern African States.
b ECOWAS, Economic Community of West African States.
c SADC, Southern African Development Community (see note 5).

ners. Trade among some RTA members is also hampered by poor transport links as a result of inadequate infrastructure. There are, however, important exceptions, including food, where substantial trade is possible between RTA members.

RTAs in Africa have largely been policy or government driven: that is, markets have been "engineered" without the necessary economic or market infrastructure and/or interlinkages among the production structures of RTA members. In many LDCs, this has been aggravated by weak institutional support. On the contrary, in Asia where DC RTAs have been so successful, production interlinkages and intra-trade expansion have evolved in the absence of a formal institutional mechanism for cooperation and integration (Onitiri, 1995, pp.35-36).

A major weakness of many of the existing RTAs, particularly in Africa, is that intraregional trade barriers have not actually been liberalized to any great extent. Agreements reached between countries to remove trade barriers have often not been fully implemented. In some cases, the goods eligible for preferential access are severely restricted through, for example, rules of origin relating to the ownership of exporting firms.

The fact that implementation of intraregional trade liberalization has been so limited among RTA members in Africa stems largely from political considerations. The distributional impact of intraregional liberalization has been large, in part because of the presence of large numbers of heavily protected industries in each of the individual countries. Hence, there have been significant numbers of potential losers to lobby against liberalization. Member governments of RTAs are reluctant to expose their domestic industries to competition because of pressures from powerful interests that may lose economic rents in the absence of protection. This reluctance is strengthened by the fear of increased unemployment if inefficient firms are not able to compete against those of regional partners.

The commitment of governments to lower tariffs in conformity with RTA agreements is also weakened by the high dependence of governments on tariff revenues, and the apparent lack of alternative tax bases to replace such revenues. Fiscal-compensation instruments designed to redress disproportionate losses suffered by some RTA members are complex and difficult to administer, particularly because of unreliable statistical data in many LDCs. As such, the costs of administering such schemes may exceed the benefits (for example, see Joshua, 1989, p.69). These problems have been exacerbated by the non-convertibility and instability of the currencies of most RTA member states that obstruct intraregional payments, weak financial infrastructure at the national and regional levels, and a lack of convergence of national economic policies (see also, Onitiri, 1995, p.43, for a discussion of some of these issues).

A further problem inhibiting effective regional integration in Africa has been the proliferation of RTAs with overlapping memberships. This has led to a duplication of activities and often conflicting regulations governing trade and other activities.

Enhancing intra-trade in DC RTAs

Despite the limited trade-creation effects of DC RTAs, in particular the African RTAs, there is some scope for facilitating intraregional trade and thereby making these RTAs more operative. Action can be initiated at the national and regional levels.

At the national level, liberalization programmes are currently being implemented in most LDCs. These may have to be complemented with policy measures aimed at infrastructural improvements, trade diversification, increased mobilization of domestic resources and at creating an enabling environment for both domestic and foreign investment.

At the regional level, efforts should be made to rationalize and harmonize the activities of RTAs with overlapping memberships; e.g. ECOWAS and the West African Economic and Monetary Union in West Africa, and SADC and COMESA in Southern Africa. Improved facilities for trade information, and the development of a range of commercial and financial services ancillary to trade promotion, are important for facilitating intraregional trade, particularly in non-traditional traded goods. If supplemented with improvements and modernization of the transportation and communication infrastructure, intraregional trade could be significantly enhanced.

DC RTAs may have to pursue with more vigour regional schemes which minimize the cost of economic integration for weaker LDC economies in order to encourage their active participation. The treaties of some DC RTAs have articles aimed at facilitating the participation of weaker economies, e.g. LDCs, but they are not fully implemented. The tariff-reduction schedules of ECOWAS under its trade-liberalization programme, vary according to three country groups created on the basis of their level of industrialization.[6] COMESA operates a scheme based on the concept of multi-speed development by which the "fastest moving member states" can agree to accelerate the implementation of specific COMESA treaty provisions or other common agreements, while allowing others, the "slowest moving member states", to join in later on a reciprocal basis. Its new treaty also provides for countries with weak economies to be assisted to explore new opportunities for the expansion of industry and manufacturing through coordinated development of agro-industries to produce semi-finished and finished goods (wa Mutharika, 1994, pp.11-13).

Box 7: Regional economic cooperation for neighbouring LDCs in Southern Africa: Prospects and problems

Southern Africa displays a variety of regional trade and economic cooperative arrangements, some of which relate to the region's history of forced accommodation to the apartheid regime in South Africa. For example, the rationale for the creation of the South African Development Community (SADC, formerly SADCC) was to reduce the dependence of the frontline states on apartheid South Africa. The demise of apartheid has opened up prospects for enhancing trade and economic integration on a wider regional basis as reflected in the creation of the Common Market for Eastern and Southern Africa (COMESA, formerly PTA), in which South Africa has an observer status, and of which two thirds of the members are LDCs.

South Africa's full entry into COMESA, which is a free-trade area with plans for conversion into a common market by the year 2000, has wide-ranging implications for its LDC members. In particular, issues like the distribution of the costs and benefits of economic integration, including the polarization of economic activities, may come to the fore. South Africa has the biggest economy in the region: between 1991 and 1993, South Africa's GDP (in current prices) was almost double that of all COMESA countries, fractionally less than the SADC total, and about

Box 7 (concluded)

eight times that of all LDCs in SADC. South Africa's economy is more industrialized and more diversified than that of its neighbours. It has better infrastructure, greater entrepreneurial skills, and its industries are generally more efficient than the largely moribund state enterprises of its neighbours.

The LDCs may suffer disproportionately from tariff revenue losses, in part because of their trade deficit with South Africa, and partly because of the large differential in tariffs on their imports and exports. The LDCs export mainly commodities with an average tariff of about 10 per cent while their manufactured imports from South Africa attract tariffs averaging about 30 per cent. Secondly, they are likely to lose some industries to South Africa which has better infrastructural facilities.

From the dynamic and institutional perspectives, the LDCs may be able to make up for some of their losses from static and distributional effects. If trade barriers are reduced and transportation services improve, the LDCs may be able to maintain some of their own industries, and some South African firms may relocate in the LDCs because of lower wages. For example, South African companies have already begun to invest in some countries in the region, including Mozambique, Malawi, Uganda and Zambia. South African companies have the capacity to undertake big infrastructural projects like railways, roads and ports. They are better capitalized than most companies of neighbouring states, and they have much better access to international financial markets. In addition, South African companies may be willing to take risks that non-regional investors might be unwilling to undertake.

To ameliorate the effects of polarization of economic activities on the LDCs, South Africa, as the largest economy, could support special programmes directed at stimulating economic growth in the LDC member countries. This may entail some economic and political benefits for South Africa itself, as sustained economic growth of its neighbours may help stem the tide of the large number of migrants entering the country illegally in search of jobs.

Intraregional trade in Southern Africa appears to be below its potential. COMESA LDC exports to other COMESA countries as a proportion of their total exports to the world declined over the decade, 1980-1990, by almost half -- from about 6 per cent to 3.4 per cent. By 1994, they had recovered only marginally and remained below their 1980 level (see table below).

The potential role of South Africa in the economic development and intraregional trade of the southern African region, within the context of regional economic integration, remains to be tapped. This may be underscored by the fear of the LDCs in the region that South Africa might dominate any such grouping and reap a disproportionate share of its benefits. On the other hand, South Africa may have been reluctant to take any strong initiatives on the issue so far because of its own domestic problems: a high unemployment rate and an unrelenting pressure for greater public expenditure on housing and other social services among others. In the meantime, some important issues, which are a legacy of past efforts of regional integration, have to be sorted out. Foremost among these is the overlapping membership of existing RTAs, for example COMESA and SADC.[1] There is the need to rationalize and harmonize the objectives and institutions of the various RTAs (or the RTAs themselves) to reduce duplication and conflicts.[2]

1 All SADC members, except Botswana, belong to COMESA.

2 In addition to intense rivalry, there is the perception by SADC members that COMESA lacks cohesion, as it embraces a diverse group of countries, and does not hold out prospects for a meaningful integration.

Table: COMESA LDCs' exports to COMESA and the world
($ Millions)

Year	*COMESA* (1)	*World* (2)	*Share (%)* (1)/(2)
1980	321.9	5419.9	5.94
1990	293.5	8527.4	3.44
1991	282.3	8381.6	3.37
1992	251.5	8326.1	3.02
1993	231.2	7403.6	3.12
1994	284.9	8045.0	3.54

Source: UNCTAD secretariat based on IMF, *Direction of Trade Statistics, 1995*.

D. Conclusions

The importance of RTAs in the world economy is unlikely to diminish despite the strengthening of multilateral disciplines. There is an ongoing process in the industrialized and developing worlds to expand RTAs, deepen integration and build stronger institutional links between RTAs in consonance with the process of globalization and liberalization. Perhaps this is also because RTAs are perceived as providing a better framework for tackling increasingly important emerging trade issues, such as services, investment and technology. The growth of RTAs has important implications for LDCs for two reasons. First, RTAs of which they are not members cover their major export markets in Europe and North America. The institutional arrangements embodied in these RTAs are therefore a potential influence on the conditions of market access of LDC exports. Some DC and LDC groups have trading arrangements with some major RTAs (e.g. the Lomé Convention) which have been useful in facilitating market access, but the asymmetrical or non-reciprocal character of these entails a risk of unilateral abrogation or revision of terms of access.

Secondly, most of the LDCs have themselves joined with neighbouring LDCs and DCs to form RTAs in the belief that closer regional integration can provide an important stimulus to their development efforts. These have had a limited impact on the trade flows and overall development of members as many factors have militated against their successful operation, including political differences exacerbated by disputes over distributional issues. It is possible to implement special measures to ameliorate the negative effects that RTAs may have on the weaker members, but this is particularly problematic for RTAs whose membership is largely drawn from the DC and the LDC groups. International assistance (or technical cooperation programmes) may be necessary to help DC RTAs to overcome this problem and in assisting LDCs to adjust to, and take advantage of, the new trading and investment opportunities in DC RTAs.

From the perspective of LDCs, it is of vital importance that the RTAs - both those of which they are members and those of which they are excluded - maintain liberal trading relationships with the rest of the world. RTAs cannot be a substitute for multilateral trade liberalization. LDCs' prospects for expanding and diversifying their exports would clearly be jeopardized if the major RTAs in the industrialized world adopt protectionist policies. Given the importance that improving export performance has for LDC development efforts, there is a powerful case for them to be given enhanced terms of market access to the major RTAs, on terms similar to those that RTAs provide for their own members.

Although DC RTAs involving LDCs have not been very effective in the past, their future prospects may be brighter because of the ongoing liberalization policies in LDCs. Liberalization should increase the efficiency of production in prospective member countries and therefore limit the possibility of polarization of economic activities due to regional economic integration. In addition, unilateral trade liberalization by LDCs will enable them to enjoy benefits from global free trade.

Regional integration generates a welfare-improving regional policy by altering the relationship between governments and the private sector (Collier and Gunning, 1995, p.396). DC RTAs (in association with developed market economy (DME) RTAs) could therefore yield enormous benefits for LDC governments as the latter become insulated from powerful business and private-sector lobbies in the area of trade-policy formulation and implementation. A strong relationship between DC and DME RTAs could have spin-offs in other respects as it would: establish credibility for trade reform, facilitate the adoption of useful institutions and serve a defensive purpose by ensuring that LDCs are in the reckoning in a world of trade blocs in which there is still insufficient experience with the enforcement of the rules and disciplines of the WTO.[7]

The proliferation of RTAs is unlikely to abate in the foreseeable future, and RTAs could well become the negotiation units in matters of international trade. It is therefore in the interest of DCs and LDCs to make existing RTAs operational, and in addition, foster special and stronger relationships with the RTAs of the DMEs in an attempt to minimize the negative trade-diverting effects of the admission of new members to the latter.

RTAs are, however, not a panacea to the economic marginalization of LDCs: under the right conditions, they may facilitate LDC access to export markets, technology and FDI, but more fundamental problems of structural constraints to expanding the production of tradeables would persist. These are unlikely to be solved by regional integration; neither would they be resolved in the short run. Domestic policies of LDCs directed at solving these supply-side constraints in the long run therefore become important if they are to reap the full benefits of regional economic integration in an increasingly global economy.■

Notes

1 The term RTA is used in an all-inclusive sense to refer to a gamut of regional trade integration schemes such as: Free Trade Areas (tariff-free movement of products with each country retaining its own tariff against third parties); Customs Union (Free Trade Area with a common external tariff (CET)); Common Market (Customs Union in which factor and product markets are integrated); and an Economic Union (common market characterized by the harmonization of monetary, fiscal and other policies) (see Robson, 1987, p.2).

2 Article XXIV of GATT, for example, was designed to restrain RTAs from adopting more protectionist policies (e.g. higher tariffs towards non-members than the pre-RTA tariffs of individual RTA members).

3 The EAC was dissolved in 1977, but a Treaty establishing a new one was signed in 1993 by the same countries, Kenya and two LDCs, Uganda and the United Republic of Tanzania.

4 The complexity of some compensation schemes, and the stringent rules of origin that reduce the volume of goods which qualify for compensation, have raised serious doubts about the size of the problem and the costs and benefits of attempting to resolve it (Joshua, 1989, p.71).

5 SADC's original objective of promoting development within the context of regional integration has been expanded of late to include issues of trade; e.g. it has a target of eliminating trade barriers within two years and creating a common currency by the year 2000. It has also launched a trade programme which would lead to a single common regional market, and, in late 1994, it negotiated a joint cooperation programme with the EU covering trade and investment promotion, among other issues (The Economist Intelligence Unit, 1995, pp.39-40).

6 Group I comprises the most developed DCs of the community - Côte d'Ivoire, Ghana, Nigeria and Senegal. The other two groups are composed of LDCs: Group II comprises Benin, Guinea, Liberia, Sierra Leone and Togo; and Group III Burkina Faso, Cape Verde, the Gambia, Guinea-Bissau, Mali, Mauritania and Niger.

7 This argument originally made by Collier and Gunning (1995, p.400) in respect of Africa could, with minor qualifications, be applied to the LDCs not only because many LDCs are in Africa but also because the LDCs have many characteristics in common with the non-LDC African countries.

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PART THREE

Financial-Sector Reforms in LDCs

FINANCIAL-SECTOR REFORMS IN LDCS

A. INTRODUCTION

A serious constraint on economic growth and structural transformation in the LDCs is the poorly developed nature of their financial systems. Levels of financial intermediation are low in relation to the size of GDP, financial systems are relatively undiversified, financial institutions (FIs) are often inefficient and their financial status is precarious due, inter alia, to the accumulation of non-performing loans and inadequate capitalization.

Most LDCs have implemented programmes of market-oriented economic reforms, often called Structural Adjustment Programmes (SAPs) over the course of the last decade. In recognition of the weaknesses in their financial systems, financial-sector reforms have been incorporated into the SAPs of a number of LDCs in recent years. Financial-sector reforms have aimed to liberalize financial markets, restructure financially distressed FIs, increase the role of the private sector in financial markets and strengthen systems of prudential supervision and regulation. The objective of the reforms is to foster the development of a domestic financial sector which is competitive, efficient and prudently managed and can provide the financial services required to support the growth of a dynamic private-entrepreneurial sector in the LDCs. The type of financial services required include the provision of short- and long-term business finance, an efficient payments mechanism, retail banking services, which are readily accessible to the public, and financial assets that provide the public with an attractive instrument in which to hold their wealth.

This chapter reviews some of the salient aspects of the financial-sector reforms implemented in the LDCs over the last few years. Section B discusses the evolution of financial-sector policies in LDCs and the rationale behind current efforts to reform financial markets. The main characteristics of financial systems in the LDCs and their strengths and weaknesses are examined in sections C and D. The objectives and policy components of financial liberalization are reviewed in section E, together with an analysis of the impact of these reforms on financial markets. Section F analyses the causes of financial distress (the insolvency and illiquidity of FIs) in LDCs and the measures adopted to restructure distressed FIs and restore them to solvency and profitability. The widespread prevalence of financial distress has emphasized the need to improve systems of prudential regulation and supervision, an issue which is discussed in section G. Section H provides some conclusions.

B. EVOLUTION OF FINANCIAL-SECTOR POLICIES

Financial-sector policies in LDCs have undergone profound changes over the course of the last three decades, shaped by trends in the prevailing development and financial theories and by the concrete experiences of individual countries. During the 1960s and 1970s, governments intervened extensively in financial markets in an attempt to control the cost and allocation of finance, although the nature and extent of intervention varied widely across LDCs. Since the 1980s, a process of financial liberalization has been under way in a number of LDCs, often alongside programmes designed to address major institutional deficiencies in their financial systems.

Most of the LDCs attained political independence during the 1960s and adopted development-oriented economic strategies. In many of these countries, especially those in sub-Saharan Africa (SSA), there was a widespread perception that the financial systems inherited from the colonial period were not providing the financial services necessary to support the developmental aspirations of governments and the public. The financial systems which had emerged during the colonial period were not well developed and were dominated by foreign-owned commercial banks concentrating on the provision of trade finance and/or lending to expatriate businesses. Discontent with the role of the foreign banks centred around their failure to extend credit to indigenous businesses and farmers, to provide long-term capital for the development of industry and to extend banking services to the rural areas. This prompted governments to adopt interventionist strategies towards domestic financial markets, an approach that was in consonance with the prevailing financial and development theories influencing policy-making throughout the world.

The financial-sector policies implemented by LDCs in the post-independence period were motivated by multiple objectives, including monetary management, mobilizing finance for the fiscal deficit and channelling credit to those sectors regarded as being at the forefront of development efforts, especially the manufacturing industry and agriculture. The latter objective was influenced by the notion that capital was scarce and thus expensive in developing countries and that this would deter the investment required for development unless governments could mobilize finance and channel it at low interest rates to investors in the priority sectors. The most important forms that financial policies took in the LDCs included the following.[1]

First, in virtually all the LDCs, as in other DCs, public-sector development finance institutions (DFIs) were established. Using funds mobilized mainly from external sources (e.g. foreign and regional development banks) and from the government budget, the DFIs provided medium- and long-term finance in the form of loans or (less commonly) equity to priority sectors of the economy. Some LDCs set up several different DFIs to fulfil specialized functions serving particular segments of the market, e.g. farmers, the manufacturing industry, small businesses, etc.

Secondly, in most LDCs, government-owned commercial banks were established, in some cases through the nationalization of existing private-sector banks, in others by setting up new banks to operate alongside those in the private sector. The government-owned banks were usually expected to serve sectors of the economy regarded as having been neglected by private-sector banks, such as African-owned businesses in the African LDCs, although, in practice, many directed most of their lending to the public sector. Many of these banks also undertook large expansion programmes to establish branch facilities in the rural areas. Most LDCs allowed private-sector ownership of banks to continue, but in a few countries, such as Benin, Guinea, the Lao People's Democratic Republic, Madagascar and the United Republic of Tanzania, the entire commercial banking system was nationalized and directed to serve the needs of centrally planned economies.[2]

Thirdly, the commercial banks, in both private and public sectors, were subject to a variety of government controls over their deposit and lending rates and the composition of their loan portfolios. Such instruments included sectoral credit directives, minimum and/or maximum nominal deposit and lending rates and the stipulation of differential lending rates for different sectors: credit to agriculture, for example, was often extended at preferential interest rates. In some LDCs, the banks were also subject to considerable informal political pressure to extend credit to particular sectors.[3] Governments in many LDCs established schemes for refinancing and/or guaranteeing loans made by commercial banks or DFIs to priority sectors: i.e. the government attempted to encourage FIs to extend credit to the targeted sectors by providing an interest rate subsidy or by standing all or part of the default risk entailed in lending to these sectors. Bangladesh and Nepal are among the LDCs that have established schemes of this nature (UNCTAD, 1994, p.56).

The banks were also subject to prudential controls, although these were often inadequate for the purpose they were intended to serve (see section G). In some LDCs, bank supervisors were more concerned with monitoring the banks' compliance with allocative credit controls and with foreign-exchange regulations than with prudential regulations. Controls related to the conduct of monetary policy, such as minimum cash-reserve ratios, liquid-asset ratios and credit ceilings, also affected the banks' operations. As fiscal deficits mounted during the 1970s, many LDC governments used their controls over the banking system, in particular the cash reserve and the liquid-asset ratios, to finance their borrowing requirements with cheap credit. One of the consequences of this was to crowd out private-sector borrowers from credit markets.

The mid-1970s saw a significant innovation in the academic financial literature with the work on "financial repression" by McKinnon (1973) and Shaw (1973). The "financial-repression" hypothesis was that government controls over financial markets discouraged the holding of financial assets and the growth of financial intermediation while preventing credit from being allocated efficiently (i.e. to those borrowers capable of using the credit to generate the highest rates of return). Controls that held nominal interest rates at levels substantially below prevailing inflation rates were regarded as especially damaging. The policy implications were that allocative controls should be removed (i.e. liberalized) allowing interest rates to rise and credit allocation to be determined by market criteria.

The policy recommendations of the financial-repression hypothesis were in accord with the growing acceptance of market-oriented economic policies among the donor countries and the international financial institutions. A further attraction of financial liberalization to policy makers in developing countries (DCs) was that one of its central policy components, the raising of interest rates, could also be used as an instrument for monetary management at a time when controlling large macroeconomic imbalances was becoming an increasing imperative throughout the developing world. In the late 1970s and early 1980s, several of the higher-income DCs in Latin America and Asia liberalized their financial markets. Financial liberalization proved somewhat problematic, however, and in the Southern Cone countries of South America, contributed to financial turbulence and an acute banking crisis (Varela, 1994, pp.23-49). As a growing number of DCs adopted programmes of financial liberalization, it became increasingly apparent that successful financial reform depended not simply upon removing distortionary government controls but also in attaining macroeconomic stability (usually by reducing fiscal deficits) and resolving complex institutional problems related to the operations and supervision of financial institutions and markets.[4]

Several of the LDCs began to introduce financial reforms as part of International Monetary Fund (IMF) stand-by agreements or Structural Adjustment Programmes in the first half of the 1980s. These reforms were initially confined mainly to raising controlled interest rates as in the Gambia and Malawi. In the second half of the 1980s and the early 1990s, a more comprehensive liberalization of financial markets, including the removal of interest-rate controls, was implemented in a number of LDCs. Liberalization has also encompassed the privatization of government-owned banks in countries such as Madagascar, and the relaxation of restrictions on entry of private sector and/or foreign banks into domestic markets as in Guinea, the Lao People's Democratic Republic and the United Republic of Tanzania. The liberalization of financial markets in LDCs is discussed in more detail in section E.

The economic crisis afflicting LDCs during the 1980s exacerbated and exposed the severity of financial fragility in a large number of LDCs. Fragility was most acute among public-sector banks and DFIs, which were often undercapitalized, had huge portfolios of non-performing loans and were incurring operating losses. As a consequence, a necessary accompaniment to financial liberalization has been the restructuring of insolvent FIs and strengthening of the financial infrastructure, in particular the regulatory and supervisory framework. The progress of these reforms in the LDCs is discussed in sections F and G.

Several LDCs have initiated efforts in recent years to promote the diversification of their financial systems, in particular by encouraging the development of primary-securities markets such as money and capital markets. These efforts have involved the establishment of institutions, such as stock exchanges, through which trade in these securities can be conducted, and the enactment of legislation to regulate these markets. The development of primary securities markets is, however, still in its infancy in most LDCs.

C. Characteristics of financial systems

Although the financial systems of LDCs display considerable heterogeneity, certain characteristics are widespread and are common to most countries. Financial systems are still largely undeveloped in terms of both depth (i.e. the volume of financial assets in relation to the size of the economy) and diversity of FIs and assets. Competition within financial markets is usually weak and FIs are often very inefficient. The financial position of many FIs, especially those in the public sector, is fragile. Services provided by formal-sector FIs are often poor, excluding large sections of the public, and, as a consequence, significant levels of intermediation take place in informal financial markets.

The financial sectors of most LDCs are dominated by commercial banks whose deposits provide the main financial assets, other than cash, held by the public (mainly because there are so few alternative financial assets available to the public, especially in the rural areas). Banking systems are almost invariably oligopolistic: a small number of government-owned banks and/or subsidiaries of foreign-owned banks control the bulk of the market, in some cases operating unofficial cartels. The lack of competition is especially marked in some of the countries that had nationalized their banking systems: in the United Republic of Tanzania, for example, one large government-owned bank holds almost 90 per cent of the total deposits of commercial banks. In a few LDCs, such as Uganda and Zambia, locally owned private-sector banks have been established since the late 1980s. New entrants into the financial system have also arrived from neighbouring countries: Thai banks have begun operations in the Lao People's Democratic Republic and Kenyan banks in Malawi and the United Republic of Tanzania. But most of the locally and regionally owned banks have not yet become large enough, nor gained sufficient credibility among the public, to provide serious competition to the established government- and foreign-owned banks. This has resulted in the segmentation of financial markets in, for instance, Uganda and Zambia: the established government- and foreign-owned banks serve large, foreign, and often profitable, corporate clients; and the local and regional banks have as their clientele indigenous businesses mainly engaged in commerce, and a few newly established enterprises in other sectors. Most often, the latter group of banks operate in the riskier end of the financial market as some of their clients would have been unable to meet the rigid lending criteria of the former, or they operate in sectors perceived as very risky by the established banks.

Despite the predominance of the commercial banks in the financial system, the banking system's monetary liabilities as a percentage of GDP are low in most LDCs and are therefore indicative of the very shallow depth of financial intermediation. In Uganda, where the banking system is particularly shallow, broad money amounted to only 8.7 per cent of GDP in 1993/94, while bank deposits accounted for only 63 per cent of broad money. Various factors have discouraged the deepening of the banking system in LDCs, including the lack of banking facilities in many rural areas, unattractive deposit rates, especially in countries experiencing high inflation, and very poor customer service. In some LDCs, commercial banks have had little incentive to mobilize deposits from the public: interest-rate controls, restrictive credit ceilings and a lack of loan demand from creditworthy borrowers have limited remunerative outlets for their funds. Moreover, operating interest-bearing deposit accounts (e.g. savings deposit accounts) for small savers is not very profitable for the banks because the operating costs are high in relation to the volume of funds involved.

Formal-sector finance to enterprises in LDCs is provided mainly by commercial bank loans, and loans/equity from the DFIs. The commercial banks concentrate on the provision of short-term, collateralized credit to the larger formal-sector enterprises in the public and/or private sectors. Most commercial banks are reluctant to extend long-term credit or to become involved in providing venture capital, arguing (with justification) that they do not have the requisite expertise or an appropriate liability structure for this type of financing. The DFIs extend longer-term finance to a variety of sectors depending on the purpose for which they were established.

In addition to the commercial banks, a variety of other FIs accepts deposits and extends credit in LDCs, although most of these FIs are small and their role in financial intermediation is relatively minor. These include building societies, leasing companies and other types of finance houses. Post-office savings banks also operate in several LDCs: they often provide a useful service as savings depositories in rural areas but generally have not been allowed to extend loans.

Contractual savings institutions, such as social security funds, provident funds and insurance companies, exist in most LDCs, often mobilizing social security contributions from formal-sector employees. These FIs mainly invest their assets in government securities or bank deposits, either because they are compelled to do so by legislation or because there are few attractive alternative financial assets available (UNCTAD, 1993, pp.57-78).

Markets for primary securities, other than government paper, are very thin. Markets for long-term securities, such as equity and bonds (capital markets), exist in only a few LDCs and, although embryonic money markets are operating in some LDCs, these are mainly limited to interbank lending, central bank rediscounting and treasury bill (TB) auctions.

The weaknesses of formal-sector financial intermediation have created opportunities for the emergence of a vibrant informal financial sector in many LDCs, supplying credit to entrepreneurs and consumers unable to access formal-sector loans and also providing retail savings outlets.[5] They are particularly important in the rural areas that generally lack formal-sector financial facilities. Informal financial markets take a variety of forms: e.g. moneylenders, pawnbrokers, loans to farmers from crop-buying agents, and group savings and credit schemes such as rotating savings and credit associations (ROSCAs). Most SSA LDCs have well-established group savings and credit systems (Popiel, 1994, p.55). In some countries, semi-formal financial institutions, such as credit unions and group-lending schemes, also play a significant role in financial intermediation: these generally have some links with the formal financial sector and/or public-sector agencies. One of the best-known examples is the Grameen Bank in Bangladesh (UNCTAD, 1993, pp.53-54; World Bank, 1989, chap.8).

D. Weaknesses of financial intermediation

The financial system performs a number of essential functions in economic development: mobilizing savings, allocating credit among competing borrowers, providing a payments mechanism for commercial transactions, spreading risk, etc. While there are differences between individual LDCs, with some having deeper, more diversified and efficient financial systems than others, important weaknesses in financial intermediation are common to a large number of LDCs.

First, the mobilization of financial savings is impeded because of the limited range of financial assets available to the public and the sometimes unattractive returns yielded by these assets. The costs and difficulties involved in opening and operating bank accounts also discourage the public from holding the main financial asset available in most LDCs, i.e. bank deposits. Depositing money and making withdrawals is often time consuming, and in many instances aggravated by unprofessional and discourteous attitude of some bank staff. There are long queues in banks, especially at the end of the month when workers' salaries are compulsorily paid into their accounts. Banks demand that minimum deposit levels, which are often prohibitive for poor people, be kept in interest-bearing accounts. Moreover, written references are often required to open bank accounts in countries where large numbers of people are illiterate.

Secondly, the commercial banking system often provides a very poor payments mechanism, forcing economic agents to conduct transactions in cash instead of through the banking system. Cheque clearing by the banks takes an inordinately long time: cheques drawn on accounts held in bank branches outside the capital city can take up to three weeks to clear in some LDCs. Transaction charges are high and mistakes by the banks are common. Financial transactions through the banking system are impeded by internal inefficiencies in the banks, by a lack of appropriate technology, especially computerization, and, in some LDCs, by the prevalence of fraud that discourages the acceptance of personal cheques.

Thirdly, significant sections of the potential credit market, in particular small-scale and informal-sector enterprises, farmers and low-income households, are often excluded from access to credit from either the commercial banks or DFIs. The main reasons for this are the high transaction costs and severe informational problems entailed in lending to these sectors, and their inability to satisfy the creditworthiness criteria (e.g. provide suitable collateral) demanded by banks and other FIs. Deficiencies in the legal system also discourage FIs from lending to these sectors because of the problems involved in foreclosing on defaulters. In some LDCs, schemes have been established to channel concessional credit from donors or government through DFIs and/or commercial banks to small-scale borrowers, but the success of these schemes in terms of the recovery rates of the loans disbursed has often been very poor.

Fourthly, there is very little long-term capital available in the LDCs to finance fixed investment. The DFIs are the main vehicle for providing long-term finance, but their ability to accommodate the needs of investors, especially those in the private sector, has been diminished for three reasons. First, a large share of their resources has been pre-empted by state-owned enterprises (SOEs), in many cases to finance recurrent losses. Secondly, the severe financial problems afflicting many DFIs, mainly due to the poor performance of their asset portfolios (which include a substantial proportion of non-performing loans), has reduced the volume of funds at their disposal. Thirdly, a large part of their resources has been provided by foreign-exchange denominated loans from external sources, the intermediation of which to domestic borrowers has often involved substantial exchange-rate risk in countries experiencing rapid exchange-rate devaluation. Other than the DFIs, there are few alternative sources of long-term finance for investors: capital markets, merchant banks and other venture-capital institutions play a significant role in very few LDCs.

Finally, financial institutions are often inefficient, providing poor services at high cost. The public-sector FIs are especially inefficient in many LDCs, particularly in countries where they have enjoyed monopoly powers, while the services provided by the major foreign-owned banks are often far below the standards they provide in the industrialized countries. Inefficiencies result from the lack of competition in financial markets, pervasive political interference in the publicly owned FIs, poor management, shortages of skilled staff, in some cases due to a lack of transparency in staff recruitment, a lack of appropriate incentives for staff to perform their duties diligently, and the failure to invest in the upgrading of technology.

E. Financial liberalization

Measures to liberalize financial systems have been undertaken in a number of LDCs since the 1980s, usually as part of stabilization or Structural Adjustment Programmes (SAPs). Financial liberalization generally has multiple objectives: boosting deposit mobilization, enhancing the allocative efficiency of financial intermediation by removing the distortions created by administrative controls, stimulating greater competition in financial markets and improving monetary control. Financial liberalization primarily entails the reduction of the allocative regulation of financial markets, as opposed to prudential regulation which has been strengthened in many countries (see section G below). The main policy components of financial liberalization programmes in the LDCs include the following:

Composition of financial liberalization reforms

Reform and liberalization of interest rates

Interest-rate reforms have been carried out in phases in most LDCs. In the first phase, controlled deposit and lending rates have been raised to levels that are closer to prevailing inflation rates, so as to reduce or eliminate negative real rates of interest. In addition, preferential lending rates applicable to priority industries have been abolished. In subsequent phases, administrative controls over interest rates have been removed, allowing banks and FIs to determine their own deposit and lending rates.

Introduction of market-based instruments of monetary control

For monetary policy purposes, central banks in a number of LDCs have replaced direct monetary-policy instruments such as credit ceilings and interest-rate controls with indirect or market-based instruments. The latter entails attempting to influence the level of interest rates and liquidity in the economy through open market-type operations (OMTOs) in combination with statutory reserve and liquid-asset requirements. OMTOs involve regular auctions of government securities, together with the provision of repurchase facilities and discount window operations by the central bank (Johnston and Brekk, 1991). OMTOs have been introduced in several LDCs including the Gambia and Malawi and, more recently, in Uganda, the United Republic of Tanzania and Zambia.

Removal of directives covering credit allocation

In most LDCs, sectoral credit directives and other allocative controls over the composition of bank-lending portfolios have been removed, allowing FIs greater commercial discretion in the allocation of credit.

Removal of restrictions on the types of activity that FIs can undertake

In some LDCs, restrictions on the types of commercial activity that different categories of FIs are allowed to undertake (other than restrictions imposed for prudential reasons) have been reduced. This has allowed, for example, DFIs to diversify away from their original specialized markets and to accept deposits, as the Agricultural Development Bank has in Nepal (UNCTAD, 1993, p.57). In addition, the liberalization of foreign-exchange markets has significantly expanded the range of commercial operations that FIs undertake, with banks and some other types of FI now engaged in foreign-exchange dealings and accepting foreign currency deposits.

Liberalization of restrictions on the entry of private-sector and/or foreign FIs into domestic financial markets

In order to encourage greater competition and to increase private-sector participation in financial markets, entry requirements have been liberalized in a number of LDCs. This has involved either abolishing legal restrictions on the participation of the private sector in domestic financial markets, as in countries such as Guinea, the Lao People's Democratic Republic and the United Republic of Tanzania where the private sector had previously been excluded, or revising banking legislation so as to make the legal framework for private-sector participation more transparent.

Privatization of government-owned FIs

A number of LDC governments have privatized or plan to privatize government-owned FIs, especially the commercial banks. Equity stakes in government-owned banks in Benin, the Gambia and Madagascar have been sold to foreign banks. The development of stock markets in a number of LDCs offers a further avenue for divesting government equity in FIs.

Impact of financial liberalization

Analysing the impact of the financial liberalization programmes in LDCs in terms of their objectives is difficult for a number of reasons. In most countries, these reforms have only been implemented very recently and are unlikely to have had significant observable effects in the short term. Secondly, some of the objectives involved, such as more efficient credit allocation or more efficient provision of services, are essentially micro-economic in nature and as such are not easy to evaluate given the type of data that are available. Thirdly, other factors besides liberalization (such as the strength of the economy) also affect developments in financial markets: disentangling the effects of different causal factors is not always possible. Nevertheless, it is possible to advance some tentative conclusions based on the experience in recent years of some of the LDCs that have undertaken programmes of financial liberalization.

There is some evidence, from research recently undertaken by UNCTAD, that liberalization has stimulated greater competition in financial markets in several LDCs, in part because of new entrants and also because of the removal of controls over interest rates. The number of banks has expanded in Uganda, the United Republic of Tanzania and Zambia with new entrants from both the foreign and the local private sectors. However, the effects of greater competition on the provision of financial services have been rather uneven, with most of the new entrants confining their operations to the urban areas. Banks have begun to compete more vigorously for deposits, offering more attractive deposit rates and innovative savings products (such as interest-bearing current accounts). They have also begun to improve customer services: many banks are investing in computer technology to speed up transactions and some are extending their opening hours. The corporate credit market in a number of LDCs is also likely to have become more competitive with the entry of banks such as Stanbic and Citibank, which are oriented towards this sector. Nevertheless, financial markets in most LDCs remain oligopolistic: the dominance of the government-owned and the large foreign banks has not been seriously challenged, and, as discussed below, the new entrants have avoided some sections of the credit markets that have long been poorly served by the more established FIs.

The impact of financial liberalization on deposit mobilization has varied, although in most LDCs the impact has probably been small in comparison to the influence of other variables such as income levels, income growth and export earnings. As noted above, banks and other FIs have begun to compete more aggressively for deposits in some LDCs and real deposit rates have risen as a result. This has been associated with some degree of financial deepening in countries, such as Malawi and Uganda, as the public increased their holdings of deposits in real terms. In Zambia, however, financial liberalization was accompanied by a marked reduction in real money balances with adverse consequences for the control of inflation: the public took the opportunity provided by financial and foreign-exchange market liberalization to increase their holdings of alternative assets, principally foreign currency and government securities (Adam, 1995).

Whether liberalization has brought about a more efficient allocation of credit is also difficult to determine. Although lending portfolios determined according to commercial criteria are likely to produce a more efficient allocation of credit than those determined by administrative controls, liberalization *per se* has probably had only a modest impact on resource allocation in financial markets for two reasons. First, one of the major sources of credit misallocation has been the lending of the government-owned commercial banks and DFIs (many of which have accumulated huge losses from non-performing loans). The removal of administrative controls

Box 8: Financial liberalization, financial markets and credit allocation in Malawi

The objectives of financial liberalization in Malawi, as in other LDCs, consist of promoting competition, innovation and diversification in the financial sector in order to enhance resource mobilization and improve the efficiency of financial intermediation. This necessitated the enactment of a new Reserve Bank of Malawi (RBM) Act in 1989, which provided the framework, *inter alia*, for overhauling monetary policy and strengthening the supervisory department of the RBM and for improving the transparency of licensing procedures.[1]

Lending and deposit rates were gradually liberalized in 1987 and 1988, respectively, although up to 1990 the RBM continued to exert informal influence on commercial bank interest rates. In 1989, the preferential lending rate for agriculture ceased, but credit ceilings remained in place until 1990. The Capital Market Development Act, enacted in 1990, provides the legal framework for trading securities, and since 1994, foreign-exchange markets have been liberalized. Fortnightly auctions of government securities coupled with reserve requirements and rediscount facilities at the RBM have provided the main instruments of monetary policy since 1991.

Data constraints render the evaluation of liberalization on the allocative efficiency of lending almost impossible, but there is evidence of some improvement in financial intermediation. First, private-sector deposits in five deposit-taking FIs in Malawi,[2] measured as a percentage of GDP, registered a strong increase, amounting to the equivalent of 16.1 per cent of GDP in 1985, 15.6 per cent in 1990 and 20.4 per cent in 1994 (RBM, 1994). However, this could also reflect the rapid increase in monetary growth, due largely to government borrowing. Secondly, there is a greater degree of commercial orientation in the banking sector: FIs contend that credit allocation is currently based solely on market-determined criteria. Thirdly, lending has been diversified to some extent: the proportion of term loans in the total loan portfolio of one of the commercial banks has increased since the late 1980s, and both major commercial banks have established leasing subsidiaries. Fourthly, competition has increased in the financial markets: there is some evidence that the two commercial banks, which still dominate these markets, have begun to operate in a less collusive manner in the setting of interest rates; their share of the financial systems' assets and liabilities is beginning to be eroded by new entrants, in particular by the rapid growth of the Leasing and Finance Company since 1986; and some other financial institutions have assumed commercial banking services or operate banking windows. Fifthly, the increased competition appears to have stimulated some innovation in financial markets. Some FIs have started offering interest on large current account and call deposits. The main FIs are striving to improve customer services: the Commercial Bank of Malawi has computerized its operations and installed automated teller machines (ATMs); the National Bank of Malawi is being computerized and plans to install its ATMs soon; and the payments mechanism has improved, significantly reducing the time spent in clearing cheques.

However, other aspects of the reforms have been less successful. New entrants into the financial markets have been limited: only one new private-sector commercial bank, the First Merchant Bank, had started operations as at June 1995, with two more, the Finance Bank of Malawi, and the Trust Bank (of Kenya), planning to start by the end of 1995. The stock exchange has yet to start trading in private securities. FIs appear to have increased their concentration on credit to medium and large corporate borrowers, due to their perception of the small-scale sector as commercially unviable. In particular, small-scale agriculture continues to suffer neglect by the FIs.

A major impediment to increased allocative efficiency is the magnitude of the governments' domestic borrowing requirement, which in 1992 and 1993 amounted to 7.6 per cent and 3.7 per cent of GDP, respectively (Reserve Bank of Malawi, 1994). The Reserve Bank of Malawi accommodated more than 50 per cent of the borrowing requirement which made a major contribution to the consumer price index (CPI) inflation rates of 23 per cent per annum in 1992/93, and 35 per cent in 1994. The remainder was financed by the banks and other FIs through the purchase of government securities that pushed TB yields to 25.1 per cent in 1993. By mid-1995, 91-day TB yields were 47 per cent. Consequently, lending rates rose to above 50 per cent in mid-1995, crowding out private-sector borrowers. Credit to the private sector as a percentage of total commercial bank assets fell by 20 percentage points during 1992-1994, while credit to the private sector from the other financial institutions (OFIs) as a percentage of their total assets fell by 9 percentage points over the same period.

Given that financial liberalization is based on the premise that, in general, the private sector utilizes resources more efficiently than the public sector, the crowding-out of the private sector from credit markets is likely to have reduced the efficiency of resource allocation in financial markets and obviated some of the anticipated benefits of liberalization. Furthermore, the continued bias of formal-sector FIs against small and medium-size enterprises (SMEs) and smallholder agriculture, which provides the livelihood for almost 90 per cent of Malawians, must give cause for concern.

1 The reforms do not entail restructuring of Malawi's two main commercial banks, as in Uganda and the United Republic of Tanzania. Compared to the commercial banks in these African LDCs, Malawian banks have been prudently managed, and have remained solvent after the impairment, and subsequent rehabilitation, of their loan portfolios in the mid-1980s.

2 These are the Commercial Bank of Malawi, National Bank of Malawi, New Building Society National Mercantile Company and Leasing and Finance Company.

Box 9: The growth of local private-sector banks in LDCs

Financial-sector reforms have stimulated the growth of local private-sector banks (LPBs) in several LDCs, including Bangladesh, Uganda and Zambia, since the late 1980s. These banks have been set up and are owned predominantly by private-sector shareholders who are nationals of the LDCs in which they operate, in contrast to the established banks which in most LDCs are government owned or subsidiaries of foreign banks. Most LPBs have been set up by local business people, often in partnership with former executives of established banks or public-sector officials. With a few exceptions, most of the LPBs are relatively small, with only a handful of branches in the major urban areas. Their lending is generally focused on the provision of short-term credit to local businesses, especially traders. The stimulus for the emergence of the LPBs has been provided by gaps in the financial markets of LDCs, financial liberalization and relatively easy entry requirements. Opportunities for new entrants to attract customers exist because the established banks often provide poor customer service and pursue very conservative and bureaucratic credit policies. The liberalization of interest rates has enabled LPBs to compete with the established banks for deposits. In a number of LDCs, the liberalization of foreign-exchange markets has opened up profitable opportunities for LPBs in foreign currency dealing, while in some countries the introduction of market-based auctions for government securities, combined with large government domestic borrowing requirements, has provided banks with highly remunerative investment outlets. In most of the LDCs where substantial numbers of LPBs have been set up, entry requirements were very low, especially in terms of minimum capital requirements, the real value of which were eroded by inflation, although these have since been raised and licensing procedures tightened with the passing of new banking legislation (see box 14).

The growth of LPBs offers both benefits and risks for LDCs. The benefits include the injection of much needed competition into financial markets, although so far this has mainly been confined to the urban areas. In comparison to the established banks, the LPBs generally offer more attractive interest rates to depositors, their customer services are sometimes more efficient, customer relations are more personalized, and opening hours are longer and more flexible. A major attraction of LPBs for borrowers is that they are prepared to process loan applications very quickly, often accepting or rejecting an application within a few days. Perhaps the most important benefit for the economy of LDCs, however, is that the LPBs have the potential to extend access to credit to small businesses and other sectors that have traditionally faced difficulties in borrowing from the established banks.

The segmentation of credit markets in LDCs, with the LPBs serving mainly the less creditworthy borrowers, entails substantial risks for LPBs (and therefore for their depositors and/or taxpayers who may have to reimburse lost deposits). Credit risks are exacerbated because LPBs must pay higher deposit rates than the established banks to attract funds, and as a result must pass on these costs through the higher lending rates charged to their borrowers. The LPBs therefore face classic adverse selection problems that undermine the quality of their loan portfolios. In addition, some LPBs have been used for insider lending, whereby depositors' money is lent to the banks' directors or their associates, usually to fund other business ventures: insider lending has been a major cause of bank failures in developing countries. Because some of the LPBs are undercapitalized (in part because of inadequate licensing regulations that allowed banks to be set up with very little capital), bad debts can very quickly render them insolvent.

The LPBs present bank supervisors with difficult challenges. The LPB sector has an important role to play in liberalized financial markets and its development should be encouraged provided that banks are managed prudently and honestly. The cost of bank failures can be high, not only because of the financial losses involved, but also because financial distress in one LPB may undermine public confidence in other LPBs that are financially sound, inducing a "flight to quality" by depositors: i.e. a transfer of deposits to the established banks that are perceived as being safer. Consequently, it is imperative that supervisors detect and limit fraudulent and imprudent banking practices in this sector, closing down the offending banks where necessary, but allowing well-managed banks the scope to compete in what will often be a difficult banking environment.

will not be sufficient to enable these FIs to operate along commercial lines and thus allocate credit more efficiently: they require major managerial, operational and balance sheet restructuring -- an issue discussed in section F.

Secondly, the credit markets for small-scale farmers and enterprises suffer from acute imperfections arising from informational deficiencies. Market failure of this nature is not amenable to a market-oriented solution. In liberalized financial markets, the banks have provided only those services that can be undertaken on a commercial basis: i.e. those from which they expect to earn a profit commensurate with the risk involved. Consequently, the banks have concentrated on supplying short-term credit to the larger corporate customers and to traders who can provide appropriate collateral, investing in government debt and trading foreign exchange. Most banks have avoided extending credit to small-scale enterprises or to smallholder farmers, arguing that this is not commercially viable because of the administrative costs involved, the high default rates experienced, and the lack of realizable security that these borrowers can provide.

The banks have also avoided the provision of long-term finance to any sectors, although in some LDCs, such as Malawi, leasing companies have entered the market for medium-term finance. Moreover, the financial problems afflicting the DFIs have curtailed the finance available from this source. Consequently, farmers, small-scale enterprises and firms needing long-term finance have found themselves largely excluded from liberalized financial markets. Some schemes have been established to channel donor funds to these sectors through the commercial banks, and some of the banks are prepared to finance farmers indirectly through crop-marketing agents, but this will probably have only a limited impact in addressing the deficiencies in these sections of the credit market.

The efficacy of financial liberalization to improve resource allocation has been undermined in several LDCs by the magnitude of their governments' domestic borrowing requirements. Large government-budget deficits in countries such as Malawi, the United Republic of Tanzania and Zambia have been financed by auctioning government securities such as TBs, the major buyers of which are the banks and other FIs. As a consequence, TB rates were driven up to very high levels.[6] This provided the bench mark for central bank discount rates and for the deposit and lending rates of commercial banks and other FIs. The high interest rates crowded out private-sector borrowers. Because of the returns available, banks invested heavily in TBs and curtailed their lending to the private sector.

Box 10: Lao People's Democratic Republic: structural change and reform in the financial sector

The Lao People's Democratic Republic's financial system has undergone dramatic changes as it has been reorganized to support private investment and growth. These changes followed the adoption in 1986 of the New Economic Mechanism (NEM) designed to remove the structural constraints to growth. In order to support the NEM, which sought to decentralize decision-making in production through greater reliance on price signals and market mechanisms, a corresponding programme of financial reforms was initiated in 1989. Key elements of the latter were:

The introduction of a "two-tier" banking system: Like central banks in other centrally planned economies, the State Bank performed both central banking and commercial banking functions. The State Bank was reorganized into a two-tier system in 1989, with commercial functions hived off to seven newly established independent commercial banks in Vientiane and the provinces. The Bank of the Lao People's Democratic Republic (BOL) was to concentrate on traditional central banking functions, i.e. "to promote and maintain internal and external monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in the Lao People's Democratic Republic, and to foster conditions conducive to orderly, balanced and sustained economic growth....."[1] While the state-owned banks were given a substantial degree of autonomy, their links with the BOL remain close, reflecting the fact that their managements are largely drawn from the old state bank system.

The recapitalization of the state-owned banks: The weaknesses of the new state banks' loan portfolios reflected the high concentration of loans to state enterprises. A technical review of these banks' portfolios undertaken in 1992 with the Asian Development Bank (AsDB) assistance revealed that almost half of the loans of the three Vientiane-based state banks were past due and an additional one-third were non-performing. To restore the viability of these banks, a recapitalization programme (of which new kip 14 billion was in government bonds and the rest in cash) of new kip 18 billion was undertaken with financial assistance from the AsDB and completed by August 1994.

Liberalizing entry to promote competition: During 1992-1995, six Thai banks and one joint-venture bank were granted licenses to operate branches in Vientiane. The increased number of banks has stimulated competition, but the market still remains dominated by one of the state banks.

Strengthening bank supervision and monitoring: The banking supervision unit of the BOL has been receiving technical assistance and training from multilateral and bilateral sources to strengthen supervisory capacity and control risks in the system. Reporting requirements were revised in 1993 and now banks are currently required to submit the following (reporting frequency shown in parentheses): foreign-exchange transactions (daily); interest rates (monthly); income statements (monthly); reserve positions (monthly); loan-portfolio details (monthly); trial-balance (monthly); and balance sheets (quarterly).

1 Bank of the Lao People's Democratic Republic Act (June 1990).

Not only did the high lending rates depress loan demand, but the banks were reluctant to lend to private-sector borrowers because they were concerned that, given the cost of credit, potential borrowers would face serious difficulties in servicing their loans.

F. Financial distress and bank restructuring

During the 1980s and early 1990s, the financial systems in many of the LDCs experienced widespread financial distress (or financial fragility) with FIs in a large number of countries afflicted by severe liquidity and/or insolvency problems.[7] Some of the worst bank failures occurred in the socialized banking systems of Benin, Guinea, the Lao People's Democratic Republic, Madagascar and the United Republic of Tanzania.[8] FIs in the members of the CFA zones in SSA were also badly affected by financial fragility.[9]

Financial distress has been particularly acute among government-owned commercial banks and DFIs.[10] In a few LDCs, such as Uganda, some of the small, locally owned banks have also run into financial difficulties. Most of the foreign-owned banks have avoided serious trou-

Box 11: Problems of state-owned banks in LDCs: The case of the Uganda Commercial Bank

During the past decade, bank distress among state-owned banks in LDCs has been widespread. State-owned commercial banks, for example, in Bangladesh, Benin, Guinea, the Lao People's Democratic Republic, Madagascar, Uganda and the United Republic of Tanzania, have been afflicted by problems of illiquidity and insolvency. The case of the Uganda Commercial Bank (UCB) illustrates the factors that caused the problems in many of these banks, in particular those arising from political interference in lending policies.

As elsewhere in post-independent Africa, the UCB was established (in 1965) partly for developmental reasons. The main objectives were to: promote banking services, facilitate the implementation of government development programmes and serve the financing needs of local or indigenous entrepreneurs. Its lending was strongly influenced by political priorities, especially in regard to a succession of administered lending schemes that were set up to provide credit to agriculture and the rural areas. The specific focus of the UCB shifted in consonance with the changes in Uganda's political landscape. It became a banker to parastatals in 1971-1972 when Ugandan Asians were expelled -- their confiscated businesses formed the nucleus of parastatals which had, by law, to do business with UCB. After the overthrow of the Amin regime, UCB increased its involvement in development financing which led to a substantial increase in its medium-term portfolio. The UCB was also used to fulfil other functions: the government used its extensive network to transfer taxes to the Bank of Uganda (BOU); and due to insecurity problems, primary and secondary school fees were paid through it into the accounts of schools operated with it. These and other social services increased the UCB's costs of intermediation.

Under the government of the National Resistance Movement, the UCB undertook a massive branch expansion which increased its total number of branches from about 100 to 188 nationwide during 1988-1990. Among other things, this involved funding agricultural investments, some of which were financed by an African Development Bank line of credit. In the absence of a good road network, numerous problems of coordination were encountered, e.g. planes were sometimes chartered to collect money from branches in West Nile. This vast rural network added to its excessive operating costs.

By the end of the 1980s, the UCB was afflicted by two major problems: it had a huge portfolio of non-performing loans and was accumulating operating losses. Its bad debts were mainly the result of political interference in lending policies, because of which loans were not extended on commercial criteria, were not properly appraised or monitored and debt recovery was not vigorously pursued. In some cases, borrowers wilfully defaulted, a problem that was exacerbated because some ministers made statements in the rural areas to the effect that government funds disbursed by the UCB were not loans and need not be repaid. The UCB also accumulated consistent operating losses. Its costs were excessive mainly because of high overheads, especially for salaries. Its earnings were low because loans were not serviced, and because many of those that were serviced were extended at subsidized interest rates and hence yielded little income.

The UCB operated with a severe shortage of capital: its initial capital base was quickly eroded by the high inflation that afflicted Uganda during most of the 1970s and 1980s, the government provided no new capital injection and its poor earnings record meant that reserves could not be built up out of retained earnings. However, poor accounting practices, which concealed problem loans, and access to automatic liquidity support from the BOU allowed the UCB to continue operating for many years despite its financial difficulties. By 1995, audits of UCB's loan portfolio revealed that about 80 per cent of it was non-performing. The UCB was insolvent.

ble, mainly because they have been conservatively managed along commercial lines: two important exceptions were the Bank of Credit and Commerce International (BCCI) and Meridien Banque internationale pour l'Afrique occidental (BIAO) -- banks which collapsed in 1991 and 1995, respectively, and which had subsidiaries in several LDCs.[11]

The main cause of financial distress has been the accumulation in the asset portfolios of FIs of large volumes of non-performing loans. The major government-owned commercial banks in Uganda and the United Republic of Tanzania, for example, both had non-performing loans amounting to around three quarters of their total loan portfolios in mid-1995. FIs in many LDCs faced liquidity shortages when borrowers failed to service their loans, and the inability to recover these loans or realize security rendered them insolvent. In many cases, FIs in both public and private sectors were particularly vulnerable to losses on their asset portfolios because they were severely undercapitalized.

The loan losses incurred by FIs in LDCs are attributable to several factors related to their management and lending policies as well as to the adverse impact of changes in the economic climate.

First, the lending policies of many of the government-owned FIs ignored basic commercial principles, with loans extended, often as a result of government directives or pressure through informal channels, to borrowers who would not have been regarded as creditworthy had commercial criteria been applied. Some of the government-owned FIs have been used as vehicles for political patronage, with pressure exerted on their officials to extend loans to politically favoured borrowers and to prevent FIs from foreclosing on defaulters. In some countries, politicians have encouraged the perception among their constituents that loans from parastatal FIs need not be repaid.

Secondly, a large share of the lending of most of the government-owned FIs was to SOEs, many of which incurred losses. Some of the SOEs were not only unable to service their original loans but also required repeated infusions of credit from their bankers to continue trading.

Thirdly, the quality of loan portfolios was impaired by poor loan appraisal, monitoring and recovery procedures, inadequate documentation of loans and loan security and by poor internal controls.

Fourthly, the economic crisis afflicting LDCs during the 1980s and the major changes in relative prices, such as exchange-rate devaluation, undermined the viability of many of the borrowers from FIs and therefore their ability to generate the funds needed to service their loans. Exchange-rate devaluations especially had serious consequences for the DFIs because a large share of their liabilities was external loans denominated in foreign exchange. In some cases, the DFIs bore the exchange-rate risk by denominating their loan portfolios in domestic currency and hence incurred losses directly when devaluation occurred. Other DFIs attempted to pass on the exchange-rate risk to their borrowers, who then faced great difficulties in servicing their loans when the capital value of the loans was inflated by devaluation. In addition, some of the DFIs have been especially vulnerable to abrupt changes in the economic environment because their asset portfolios have been relatively undiversified as a result of their being oriented on specific sectors.

Fifthly, financial distress in some FIs has been the result of fraud, probably the most common form of which is insider lending whereby the owners, directors or managers of FIs direct loans to themselves or to companies in which they have interests. Fraud was a major cause of the bank failures in Guinea: fictitious assets accounted for 76 per cent of the total assets of the six government-owned banks which were eventually closed down in 1987 (Sheng, 1994, p.256). Insider lending has been an important cause of bank failure among locally owned private sector banks in many LDCs.

In addition to the problems caused by non-performing loans, the financial condition of FIs was undermined by high operating costs and inefficiency. Many of the public-sector FIs became overextended in terms of staffing levels and branch networks and, as a result, their operating expenses exceeded incomes.

The losses incurred by many insolvent FIs in LDCs were initially concealed by cosmetic accounting practices (such as the accrual of unpaid interest) and inadequate supervision on the part of the regulatory authorities, until the scale of financial distress had escalated to the point where it could no longer be ignored. This often occurred when budgetary or monetary constraints prevented governments or central banks from continuing to accommodate the liquidity requirements of distressed FIs, or when audits of the FIs were performed in preparation for financial-sector reform programmes. The cost of the measures that were eventually implemented to remedy financial distress was greatly increased by the delays in, first, diag-

Box 12: Restructuring state-owned banks in LDCs: the Uganda Commercial Bank and the Tanzania National Bank of Commerce

Restructuring distressed state-owned banks is an essential component of financial reform programmes in a number of LDCs where such banks have exhibited severe financial and managerial weaknesses. These weaknesses include, *inter alia*, undercapitalization, weak internal controls, poor internal accounting and auditing procedures, excessive overheads, low earnings, and in particular, large portfolios of non-performing loans. In Uganda and the United Republic of Tanzania, for example, state-owned commercial banks have been found to be technically insolvent and require large infusions of new capital to repair their balance sheets and restore their liquidity.

Both the Uganda Commercial Bank (UCB) and the Tanzania National Bank of Commerce (TNBC) got into distress for similar reasons. They were subject to considerable government intervention in respect of lending policies and branch expansion. Market criteria were not used to determine credit allocation; instead loans were extended to priority sectors to meet political objectives. Foreclosing on defaulters was a slow process in difficult legal environments riddled with corruption and shortages of lawyers. In addition, many loans extended in the past on political directives were not properly administered (e.g. documentation was poor) and hence it was difficult to recover them. In the United Republic of Tanzania, most of the TNBC's lending was to parastatals and crop marketing boards that did not service their loans. TNBC's non-performing loans are reckoned to be about 70 per cent of the banking system's assets. The consequences of bank distress are particularly acute in the United Republic of Tanzania because TNBC has been the linchpin of a state monopolistic banking structure since the late 1960s. Both the UCB and TNBC dominate the formal financial sector in their respective countries in terms of branch network, assets and deposits.

The restructuring programmes of UCB and TNBC have similar objectives:

(i) *Repairing the balance sheets:* Non-performing loans are being removed from the banks' balance sheets and transferred to a new body, called the Non-performing Assets Recovery Trust (NPART) in Uganda, and the Loans and Assets Recovery Trust (LART) in the United Republic of Tanzania, and replaced with government bonds. The banks are also receiving capital injections from their owners - the Uganda government has increased its equity in UCB from 273 million shillings to 10 billion - but in neither bank has the process of balance-sheet restructuring been completed.

(ii) *Reducing operating costs*: Both banks are downsizing by closing loss-making branches, retrenching staff and rationalizing their management to reduce excessive operating costs. The UCB had 188 branches before restructuring; this has been reduced to 85 branches and 53 agencies while staff numbers at UCB have been cut by almost 50 per cent.

(iii) *Reorganizing management and operational procedures:* Management of both UCB and TNBC is being reorganized with foreign technical assistance whose recruitment has been facilitated by World Bank/IMF loans. Development and other non-commercial functions are being cut back, with attention focused on improving earnings performance. Lending policies are being reviewed to strengthen loan appraisal, monitoring and recovery procedures. Lending to parastatals is now subjected to the same commercial criteria as lending to the private sector. Internal accounting and auditing procedures have been streamlined so that accounts reflect the true state of the banks' balance sheets, earnings and asset quality.

The restructuring programmes of UCB and TNBC have not yet resolved a number of important and contentious issues. Branch closures have met with political resistance because of the fear that people in rural areas will be denied access to banking services in the future. Plans for privatization have raised similar fears as private-sector investors might not be interested in areas of marginal profitability such as rural finance. Rural branches are important for deposit mobilization and for the introduction of banking culture to rural people. Whether a nationwide banking network can be viably maintained by a bank operating according to strictly commercial principles remains to be seen.

nosing the problems facing FIs and, subsequently, taking appropriate action.

In dealing with financial distress in LDCs, several different approaches have been adopted by governments and monetary authorities. Insolvent FIs have been liquidated in countries such as Benin, Guinea, Niger, Togo and the United Republic of Tanzania. In Guinea, all of the six government-owned banks were closed after it was found that almost all their loans were irrecoverable: these banks were replaced by three privately owned banks with foreign participation (World Bank, 1989, p.71).

Most distressed FIs have not been liquidated but have instead undergone some form of rehabilitation or restructuring. In some cases, the size of the distressed FIs makes closure problematic. Liquidating FIs that account for a large share of financial markets - such as the Uganda Commercial Bank or the National Bank of Commerce in the United Republic of Tanzania - would risk destabilizing the financial system and would deprive large sections of the population of access to banking services. Political considerations also discourage liquidation in many LDCs. In countries such as Madagascar, the authorities have attempted to enhance the liquidity and restore the viability of FIs through a combination of increased interest-rate spreads, the provision of subsidized credit to FIs, and deregulation to allow FIs to diversify into more profitable lines of operation.[12] In many cases, however, solutions of this nature have not been adequate for two reasons. First, the magnitude of the losses facing FIs has been too large to be alleviated simply by boosting their profitability. Secondly, because the financial distress afflicting these banks has been caused primarily by internal management failures, radical changes in their management structures have been required to prevent the same problems from recurring.

As a consequence, it has been necessary to restructure the balance sheets and management of FIs in a number of LDCs, often with the support of the World Bank or other aid agencies under financial-sector reform programmes.[13] Balance-sheet restructuring has entailed the injection of additional capital to restore net worth to positive levels. Capital injections, especially into the parastatal FIs, have usually been provided by governments, but in some cases the private sector has been prepared to invest in distressed banks: foreign banks have purchased equity in government-owned FIs in Benin and

Box 13: Bangladesh: the financial-sector reform programme and the problem of large-scale loan "defaults"

Key elements of the financial-sector reform programme (FSRP): The programme was initiated in 1990 with financial and technical assistance from multilateral and bilateral donors. Its main objectives have been to improve the overall functioning of the banking system and restructure the nationalized commercial banks (NCBs). Key elements of the FSRP include:

- The gradual deregulation of interest rates;
- Eliminating subsector-specific subsidized lending programmes;
- Allowing new private banks to operate: there are now 20 private commercial banks (two are privatized NCBs) that compete against the four remaining NCBs;
- Recapitalizing the NCBs;
- Expanding managerial training programmes at the NCBs;
- Developing modern management information systems, extending the use of computers at the NCBs;
- Enhancing central bank supervision and surveillance capacity through training in modern supervision techniques and setting up a credit information bureau to monitor large loans;
- Modernizing the legal framework by setting up special financial courts (1990), and with the Banking Companies Act (1991) and the Financial Institutions Act (1993);
- Setting targets for risk-weighted capital adequacy ratios for private commercial banks (6 per cent) and NCBs (5 per cent);
- Strengthening accounting and audit practices;
- Improving loan classification and provisioning norms and standardizing these across banks;

FSRP achievements: Progress has been achieved in financial liberalization, strengthening the regulatory capacity of the central bank, and in recapitalizing the NCBs. However, the banking system's deep-seated structural problems, as well as weaknesses in management and operating procedures, have proved less amenable to policy actions. As a result, serious inefficiencies in intermediation, loan appraisal, portfolio risk-management and credit allocation remain.

Loan defaults: The banks remain burdened by a large overhang of undercollateralized bad debts or loan "defaults", conservatively estimated at the equivalent of 5 per cent of GDP. The high volume of bad debts has forced a tightening of lending policies and a widening of interest margins. This phenomenon has also given rise to concerns about the development of a "default culture" among borrowers - a small number of whom account for a large share of these bad loans - who exploit shortcomings in the legal system to avoid repayments or penalties. The primary factor underlying the high rate of bad loans differs: in the NCBs it reflects their provision of directed credit to loss-making state-owned enterprises and lending to politically well-connected borrowers, while in the private banks the main problem has been insider lending. The scale of the defaults has made the issue of systemic importance, but progress in improving repayment rates has been modest to date.

Madagascar, and in a private-sector bank in the United Republic of Tanzania (the local subsidiary of Meridien BIAO).

Balance-sheet restructuring has also involved removing non-performing loans from the asset portfolios of FIs. These have either been written off against loan loss provisions if the reserves were sufficient to allow this or replaced by long-term assets, such as bonds, supplied by the government or monetary authorities.[14] In some LDCs, a new institution has been established to recover non-performing loans, as in the Gambia, Uganda and the United Republic of Tanzania; in others, such as the Lao People's Democratic Republic, the responsibility for loan recovery has been assumed by the central bank. Central banks in a number of LDCs have also taken over the foreign-exchange liabilities of DFIs. Balance-sheet restructuring has generally had substantial budgetary costs for the government.

The second major element of restructuring distressed FIs has involved changes in management, operating procedures and organizational structure. Efforts have been made to improve loan-appraisal techniques, the documentation of loan security, the monitoring of loans and loan-recovery procedures, internal controls and accounting practices. To reduce operating costs and overheads, the branch structure of some of the government-owned commercial banks has been, or is in the process of being, rationalized, often by closing substantial numbers of branches whose profitability is marginal or negative.[15] In addition, staffing levels have been reduced and layers of management removed. In some LDCs, governments are hoping that the radical changes in management necessary to restore parastatal FIs to profitability can be brought about through their privatization.

G. Bank regulation and supervision

The objective of the prudential regulation and supervision of banks and other FIs is to minimize the risk of bank failure caused by imprudent or fraudulent banking. This is motivated by two related concerns. The first is to protect depositors and taxpayers (who might have to bail out failed banks or reimburse lost deposits). The second is to promote public confidence in the safety of the banking system and ensure that any bank failures that do occur do not have systemic effects, caused for example by runs on deposits, which would have potentially damaging consequences for the payments system and for credit availability and therefore for the non-financial sectors of the economy.

Prudential systems consist of two elements: a regulatory framework composed of banking laws and other relevant statutes, and the institutional mechanisms for supervising banks to ensure compliance with regulations and sound banking practices. The prudential systems in LDCs are a product of the historical development of their financial systems during the colonial and post-independence periods and of more recent reforms prompted by the banking crises described in the preceding section.

Prudential regulation was not accorded a high priority in most LDCs during the colonial period and the immediate post-independence period. Most of the banks operating during the colonial era were subsidiaries of well-established and conservatively managed foreign banks and, as a result, the LDCs had little first-hand experience of bank failure (Harvey, 1993). Moreover, the focus of financial policy was on the need to direct credit allocation in line with developmental objectives, as noted in section B above, rather than on the prudential aspects of intermediation. In the former British colonies, the banking laws and supervisory institutions were modelled on those of the United Kingdom and underwent only minor modifications in the period following independence. In contrast, the nature of FIs (particularly in terms of their ownership) and of their lending policies changed radically in many LDCs in this period.

The banking crises that occurred during the 1980s exposed fundamental deficiencies in both banking laws and supervisory systems in the LDCs (as they did in many other developing and developed countries throughout the world). The banking laws had become outdated and deficient in several respects. The real value of minimum capital requirements was eroded by inflation in many countries,[16] the laws failed to take account of some of the major sources of risk facing banks, such as insider lending and loan concentration, and to compel banks to classify loans properly according to their quality (i.e. whether they were being serviced and could be recovered) and make provisions for bad debts. Even in cases where mismanagement was detected, the banking laws often failed to give central banks authority to take action against imprudently managed FIs. Moreover, the DFIs and some other FIs in LDCs were usually outside the orbit of the supervisory authorities, whose jurisdiction was confined to the commercial banks.

In addition to the inadequacies of the banking laws, bank supervisors lacked sufficient trained staff. In many countries, they were unable to carry out on-site inspections of FIs, while they did not receive the type of information from banks required for effective off-site supervision, such as information on loan quality, credit exposure to large borrowers or income and expenses statements. Moreover, supervision departments in central banks often lacked the political independence needed to enforce compliance with banking laws, particularly by government-owned FIs. Instead, central banks often accommodated the liquidity requirements of distressed banks by granting them large overdraft facilities, a practice that simply allowed these banks to continue accumulating losses long past the point where corrective action should have been initiated.

The importance of effective prudential regulation and supervision of FIs is now recognized in most LDCs. This has been reflected in legislative and institutional reforms to strengthen prudential systems, particularly in countries that have implemented financial-sector reform programmes. Many LDCs, including Malawi, Uganda, the United Republic of Tanzania and Zambia, have enacted legislation to strengthen their banking laws: in doing so, this has brought them closer into line with international standards such as those set out in the Basle Accords.[17] The legislative changes have entailed providing bank supervisors with the authority and flexibility to impose prudential standards of operation on the FIs they supervise. Entry requirements in terms of minimum capital and suitability of owners and managers have been raised and capital adequacy ratios amended to relate minimum capital to risk assets. Restrictions on loan concentration, insider lending and investment in non-banking businesses have been imposed. Requirements for proper accounting, loan classification, the treatment of unpaid interest, and provisioning for non-performing assets have been introduced. Bank supervisors have been empowered to demand from FIs regular and timely balance-sheet information relevant for effective supervision (box 14).

The revisions to the banking laws have also strengthened the authority of bank supervisors to take action against imprudently or fraudulently managed banks. Supervisors have been given the power to impose fines for infractions of the banking laws, to issue cease-and-desist orders to the management of FIs, to replace management where appropriate and to liquidate insolvent FIs. The Bank of Uganda closed down one insolvent bank in 1994, and in April 1995 replaced the management of two other locally owned banks whose balance sheets had been impaired through insider lending and very poor internal financial controls. In some LDCs, the revised legislation has brought previously unsupervised FIs, such as building societies and DFIs, under the supervisory authority of the central bank. Legislative changes have been accompanied by programmes to expand and upgrade the staff and resources available to bank supervision departments.

Despite the improvements to the banking legislation and supervisory capacities carried out in recent years, it is very likely that most LDCs are still some way from attaining effective prudential systems. Staffing constraints remain acute, in some countries the legislation is still deficient in many respects, and the supervisory process has not been insulated from political interference. Moreover, financial liberalization is likely to expose FIs to risks for which they have only limited experience and expertise in managing. The liberalization of interest rates and foreign-exchange markets will expose FIs to market risk arising from interest-rate and exchange-rate fluctuations. Managing credit risk may become more difficult for FIs because many of them have had very little direct experience of allocating credit according to commercial criteria, while the increased competition in financial markets may force FIs to cut interest-rate spreads, which at present accommodate some of the costs of inefficient management.

The growth of locally and regionally owned private-sector FIs poses particular challenges for bank supervisors in LDCs. These FIs have the potential to play an important role in the economic development of the LDCs, especially by serving segments of the credit markets that have been neglected by the foreign-owned and parastatal banks. However, some of the locally and regionally owned FIs are undercapitalized, have weak management and are often operating in the most risky segments of the market on very narrow interest-rate margins. In addition to the well-publicized case of Meridien BIAO, a number of small locally owned banks have collapsed or been taken over by central banks in several LDCs in the last few years. In enforcing prudential regulations, supervisors may face difficult dilemmas arising from the desire to

Box 14: Strengthening prudential legislation in LDCs

An integral part of financial-sector reforms in many LDCs has been the revision of the prudential legislation governing banks and other financial institutions. The existing legislations were deficient in a number of important respects. They often failed to provide central banks (or other institutions charged with supervisory functions) with the legal authority to enforce compliance with the banking laws. In many LDCs, the legislation failed to adequately restrict some of the major sources of risk facing banks such as insider lending and loan concentration, nor to ensure that banks properly classified, and made loan loss provisions for, non-performing loans. They were inflexible, making no provision for central banks to issue or update prudential regulations whenever appropriate. The real value of minimum capital requirements was eroded to very low levels by inflation in several LDCs, allowing undercapitalized banks to be established. The legislation often lacked provisions for tackling bank insolvency with central banks having only very limited powers to intervene when banks ran into distress. In addition, the DFIs and other FIs were often not subject to the supervisory authority of the central bank, but (if supervised at all) to other institutions, often government ministries, which lacked the technical expertise for this task.

Over the last few years, many LDCs, including Bangladesh, Ethiopia, Malawi, Uganda, the United Republic of Tanzania and Zambia, have enacted legislation to strengthen the laws governing banks and other types of financial institution, and to bring them closer into line with international standards such as those set out in the Basle Accords. The new legislations in these LDCs are not identical but most have a number of basic elements in common.

Capital adequacy has been accorded increased emphasis in prudential regulation throughout the world. As such, LDCs have raised (often by a multiple of the previous minimum level) the minimum capital required to establish a bank and have amended capital adequacy ratios to relate a bank's capital and reserves to its risk assets. Restrictions on loan concentration, insider lending and investment in non-banking businesses have been tightened and their coverage made more precise. Requirements for proper accounting procedures have been introduced: banks are now required to classify loans according to their servicing record (i.e. loans on which service payments are overdue by more than a specified minimum period are classified as non-performing) to suspend accruing unpaid interest to income, and to make appropriate provisions for non-performing assets.

In several respects, the new laws are more flexible than the legislation that they replaced, in particular because they allow central banks to issue prudential guidelines and directives to banks whenever the authorities feel this is appropriate, without having to enact new, or amend existing, legislation. This, for example, can allow central banks to raise minimum capital requirements to take account of inflation, or to issue directives stipulating the information to be supplied by banks to the supervisors. In several LDCs, legislative changes have given the central banks a greater degree of independence to undertake supervisory functions from other government institutions, in particular finance ministries, which commonly had final authority in a number of key areas related to the banking system. In some LDCs, the revised legislation has brought previously unsupervised FIs, such as building societies and DFIs, under the supervisory authority of the central bank.

The new banking laws have also strengthened the authority of central banks to take action against imprudently or fraudulently managed banks. Supervisors have been given the power to impose fines for infractions of the banking laws, to issue cease-and-desist orders to the management of FIs, to replace management where appropriate and to liquidate insolvent FIs.

allow FIs in this sector the opportunity to develop and provide much needed services to the public and the need to protect depositors, taxpayers and public confidence in the financial system.

H. Conclusions

Important policy reforms have been implemented in the financial sectors of many LDCs in recent years. Financial systems have been liberalized with the reduction or removal of allocative controls over interest rates and lending, the introduction of market-based techniques of monetary control, and the easing of entry restrictions on private capital. The financial fragility of some of the major parastatal banks in LDCs is being addressed with programmes to restructure management, organization and balance sheets. Measures have also been taken to revise banking laws and strengthen bank supervision departments in order to ensure more effective prudential regulation of the financial system.

The reforms have started to bring about some improvements in the financial systems of LDCs. Commercial principles are assuming a greater role in determining the creditworthiness of potential borrowers and in the overall operations of the parastatal FIs than was the case a few years ago, and there is a realization among all FIs that customer services must improve and that losses will not be subsidized indefinitely by taxpayers. New entrants have stimulated more competition, particularly in deposit mobilization and there are indications that banks are beginning to improve and expand the range of services they offer to the public, particularly through investment in new technology.

Despite the improvements brought about by reform, serious deficiencies remain in the financial sectors of the LDCs. Access to finance by important sectors of the economy, such as smallholder farmers, small-scale enterprises and investors requiring long-term finance is very limited. Because of market imperfections, it is unlikely that commercially oriented FIs will be able or willing to address the financing needs of these sectors. Non-market solutions will probably be required to service these sectors, but effective institutional mechanisms for delivering finance to them have not been established in most LDCs.

A second area of concern relates to the future role of parastatal banks, particularly in those LDCs where they hold a dominant share of the financial markets. These banks cannot be closed down without causing serious disruption to the financial system. Instead, restructuring programmes are being implemented or are planned that aim to restore these banks to profitability. Yet the difficulties involved in these restructuring exercises are substantial. A radical change is required not only in the organizational structure and management of these banks but also in the working culture of their employees. The financial costs of restructuring (which will ultimately be borne by taxpayers) are enormous, and there are likely to be political constraints to the type of major rationalization of branch networks and staffing levels that are needed to restore viability to these banks. Rationalization may also pose acute dilemmas for governments anxious to ensure that rural areas are not deprived of basic banking services.

Efficient financial intermediation requires both economic stability and a fiscal stance that does not pre-empt private savings for government expenditure. In a number of LDCs, excessive government borrowing is undermining the efficacy of financial-sector reforms, with interest rates being pushed up to levels that are prohibitive for most private-sector borrowers, but which allow FIs to make relatively risk-free profits by investing in TBs. The private sector has consequently been crowded out of credit markets.■

Notes

1 The various forms of government intervention in financial markets in developing countries are described in World Bank, 1989, chap.4.

2 Most of the branches of the existing foreign-owned banks in Uganda were also nationalized during the 1970s, although these banks retained a few branches in the main urban areas.

3 In Malawi, for example, the commercial banks extended a large share of their loan portfolio to the estate tobacco industry in the 1970s, mainly as a result of political pressure. This industry was regarded as a priority sector for the government and a number of politicians and their associates had invested in tobacco estates.

4 See McKinnon, 1988 and Villanueva and Mirakhor, 1990.

5 Informal finance refers to financial activities that are lawful but are unregulated by the monetary/ financial authorities (Popiel, 1994, p.54).

6 In Zambia, the 91-day TB yield peaked at 182 per cent in June 1993. In December 1994, 91-day TB rates reached 41 per cent in Malawi and 72 per cent in the United Republic of Tanzania. (Data from the Bank of Zambia, Reserve Bank of Malawi and Bank of Tanzania Annual Reports.)

7 Illiquidity denotes the inability of an FI to accommodate day-to-day demands for withdrawals from holders of deposits or other short-term liabilities, and to pay for operating expenses. Insolvency denotes the situation in which an FI’s liabilities, other than to its own shareholders, exceed the value of its assets. Illiquidity and insolvency are often linked, although this is not necessarily the case. Liquidity problems often occur when loans are not serviced and are an indication that an FI may be insolvent or close to becoming insolvent.

8 The six government-owned banks in Guinea had incurred losses amounting to 80 per cent of their loan portfolio by 1985 (World Bank, 1989, p.105). In Madagascar, doubtful loans amounted to 40 per cent of the banks’ loan portfolio in 1986 (World Bank, 1992).

9 A distinctive characteristic of many FIs in the

CFA zones is that their loans have exceeded their deposit base with central bank refinancing providing a significant proportion (around one third) of their loanable funds. In non-CFA countries in SSA, the opposite has usually been the case, with FIs holding large volumes of liquid assets, often to meet statutory requirements. Their balance sheets have therefore been less vulnerable to problems arising from non-performing loans (Popiel, 1994, pp.47, 57).

10 DFIs in almost all LDCs have experienced financial difficulties, with two notable exceptions; INDEBANK in Malawi and the Botswana Development Corporation (Johnson, 1994, p.177).

11 The Meridien Bank had its origins in Zambia. It had grown very rapidly in Zambia (to become the fourth largest bank in the country) and had expanded into several African countries.

12 These types of solution are referred to as flow solutions by Paul Popiel (1994, p.58).

13 The Asian Development Bank has also been involved in providing resources for the restructuring of FIs in countries such as Laos, while USAID and DANIDA have provided assistance to FIs in Uganda and the United Republic of Tanzania.

14 One of the rationales for this type of solution is to repair the balance sheet of the distressed FIs without putting excessive pressure on the public-sector budgets; replacing bad debts with long-term bonds allows the budgetary costs to be spread out over a long period of time. However, because these are long-term assets which are usually non-tradeable, and because, in some cases, they yield below-market rates of interest, this type of solution may lead to liquidity shortages for the FIs involved.

15 Invariably, the rationalization of the branch structure of government-owned banks in many LDCs has involved closing rural branches and/or transforming some of them into agencies, which reduced the access of rural areas to formal banking services. One exception is the United Republic of Tanzania where the restructuring plan of the National Bank of Commerce aims to keep the nationwide payments system by closing mostly urban branches.

16 In the early 1990s, it was possible to establish a bank in Zambia with a minimum capital in local currency equivalent to only £30,000.

17 The Basle Accords and related work of the Basle Committee on Banking Supervision are discussed in Cornford (1993).

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ANNEX I

Report of the High-level Intergovernmental Meeting on the Mid-Term Global Review on the Implementation of the Programme of Action for the Least Developed Countries for the 1990s

(New York, 25 September - 6 October 1995)

The following paragraphs cover the recommendations (paras: 36-50) of the High-level Intergovernmental Meeting (TD/B(LDC/GR/8):

Recommendations

36. The present recommendations are based on the assessment of progress in the implementation of the Programme of Action for the Least Developed Countries for the 1990s presented above, as well as on information contained in *The Least Developed Countries,1995 Report,* and recommendations made by the expert groups convened by the UNCTAD secretariat as part of the preparations for the High-level Intergovernmental Meeting on the Mid-term Global Review on the Implementation of the Programme of Action. These recommendations cover a number of key areas of concern for the LDCs.

I. Major Challenges

37. The challenges facing LDCs in the second half of the 1990s are to reverse the decline in economic and social conditions, to promote sustainable economic growth, development and structural transformation and to avoid becoming further marginalized in the international economy. An intensified policy commitment by both LDC Governments and the international community will be required to meet these challenges. In implementing domestic policies, LDCs should endeavour to focus on measures to restore and maintain macroeconomic stability; to promote the growth and diversification of exports; to strengthen an enabling environment for private sector investment and entrepreneurship; to enhance human resource development; to continue to implement population and development programmes with full respect for the various religious and ethical values and cultural background of each country's people; to adhere to basic human rights recognized by the international community which strike an optimal balance in the interrelationship between their population, their natural resource base and the environment, taking into account economic imperatives; to strengthen the infrastructure; to promote good governance as mentioned in the Programme of Action; to broaden popular participation in the development process; and to ensure the full utilization of human resources along with democratization, promotion of good governance, observance of the rule of law and peaceful resolution of any civil conflicts where such conditions exist. The broad outlines of a domestic economic policy framework conducive to meeting the challenges facing the LDCs are delineated below.

II. The Economic Policy Framework

38. (a) Macroeconomic stability would require rationalization and sound management of public expenditure, properly planned monetary growth and maintenance of appropriate exchange rates commensurate with ensuring a sustainable external balance;

(b) Policies to increase export earnings, including appropriate exchange rate and trade policy reforms to reverse the decline in the share of world trade of the LDCs, diversify the composition of their export structure and to facilitate their ability to exploit opportunities arising from the Final Act of the Uruguay Round, are essential;

(c) This will entail strengthening of existing policies and measures for the promotion and support of the private sector complemented with public investment, including policy-based incentives or the adoption of new policies and measures where necessary;

(d) The potential for economic and technical cooperation between LDCs and other developing countries merits further exploration. The international community should help LDCs promote trade links and should take appropriate measures to support such trade links, particularly sub-regional and regional trade. Such trade could be promoted by identifying complementarities in production structures among countries, strengthening the institutional and human capacities for the operation of sub-regional trading arrangements, establishing sub-regional trade information networks, and associating the private sector more closely with the integration process. There are potential gains for the LDCs in participating in the Global System of Trade Preferences among Developing Countries (GSTP). LDCs should be encouraged to accede to the GSTP and be provided with appropriate technical assistance to enable them to benefit fully from the system. Least developed countries should strengthen sub-regional, regional and inter-regional cooperation in order to benefit from economies of scale and to attract foreign direct investment more easily from developed and other developing countries. More attention should be given to promoting triangular cooperation and technical cooperation among developing countries (TCDC) as well as South-South joint ventures and ECDC investment in these countries;

(e) The growth of a dynamic private enterprise sector requires an appropriate economic, fiscal and legal framework. Essential features of this framework are stable and predictable policies, tax, monetary and trade policies which ensure adequate incentives for investment, and a legal system which protects property rights and commercial contracts. These features are also needed to tap into international capital flows in the form of direct and portfolio investments;

(f) Enhancing human resource development is imperative if LDCs are to raise productivity, output and living standards. With the support of the international community, LDC Governments should intensify their efforts to raise education and training standards, promote life-long learning, improve the health status of their populations, and strengthen the status of women by implementing appropriate policies in accordance with the provisions of the International Conference on Population and Development and the Fourth World Conference on Women;

(g) To enable women in LDCs to play their full role in development, efforts should focus on legislative and administrative reforms to give women full and equal access to economic resources, including the right to inheritance and to ownership of land and other property, credit, natural resources and appropriate technologies, and to involve women directly in planning, decision-making, implementation and development of macroeconomic and social policies, programmes and projects. Special initiatives and innovative schemes which can give women increased access to credit, training, information on marketing channels, as well as other support services, to alleviate the burden of their role as mothers and housewives, should be adopted;

(h) The economic policy strategies adopted by the LDCs should be consistent with the need to eradicate the chronic levels of poverty afflicting these countries, in particular by promoting the development of the private sector and entrepreneurship, by ensuring that all people have access to productive resources, and benefit from a policy and regulatory environment that enhances their overall capacities and empowers them to benefit from expanding employment and economic opportunities;

(i) LDC Governments are attempting to implement comprehensive structural adjustment reforms in very difficult circumstances, often in the face of severe administrative and financial constraints. Many of the constraints that they face are structural, deep-seated and not amenable to short-term solutions. Consequently, successful structural adjustment reforms require a Government commitment to reform, and a medium-term to long-term perspective for implementation;

(j) In order to ensure that structural adjustment programmes include social development goals, in particular the eradication of poverty, the generation of productive employment and the enhancement of social integration, LDC Governments, in cooperation with the international financial institutions and other international organizations, should:

(i) Protect basic social programmes and expenditure, in particular those affecting the poor and vulnerable segments of society, from budget reductions;

(ii) Review the impact of structural adjustment programmes on social development by means of gender-sensitive social-impact assessments and other relevant methods, and develop policies to reduce their negative effects and improve their positive impact;

(iii) Further promote policies enabling small enterprises, cooperatives and other forms of micro-enterprises to develop their capacities for income generation and employment creation.

(k) Agreeing on a mutual commitment between interested developed and developing country partners to allocate, on average, 20 per cent of ODA and 20 per cent of the national budget, respectively, to basic social programmes, and in this context, the proposal of the Government of Norway to host a meeting in 1996 among interested countries and representatives of relevant international institutions, with a view to considering how the 20/20 initiative can be applied operationally, is welcomed;

(l) Commitment of the LDCs and the assistance of the international community are essential components for the success of structural adjustment programmes. Without such support, the long-term objectives and the sustainability of the programmes will be jeopardized. In this regard, therefore, renewed commitments by the international community as defined by the Paris Programme of Action and other relevant instruments to support the efforts of the LDCs with adequate resources is vital.

III. External Trade and Investment

39. The extremely low export capacity of LDCs, their very low level of export receipts, as well as their fluctuation and the resulting sharp limitation on their capacity to import, are the major structural constraints to developing LDC trade. This situation is more acute in the case of land-locked and island least developed countries, as their external trade is further impeded by high transportation costs.

40. Action by the international community, including increased technical assistance as foreseen in the Marrakesh Ministerial Decision on Measures in Favour of LDCs, complemented by adequate financial support, can help LDC efforts to increase export earnings through increased production in both the traditional and the modern sectors of the economy, through diversification of the commodity structure and export markets, and thereby help to obtain better prices for their export commodities. It can also help LDCs to mitigate any adverse effects of the implementation of the Uruguay Round agreements and to integrate themselves better into the international trading system. The interest of LDCs regarding the idea of considering the setting up of a ‘safety net’ to help them cope with any such effects in the immediate and short term was noted. The Final Act of the Uruguay Round of multilateral trade negotiations, including the special clauses providing differential and more favourable treatment, and the decision on measures in favour of least developed countries, provide the institutional framework for these matters.

A

41. All provisions of the Final Act of the Uruguay Round should be effectively applied. In this regard, concrete action, as appropriate, should be taken, consistent with the Final Act, to fully and expeditiously implement the Marrakesh Declaration as it relates to LDCs, and the Ministerial Decision on Measures in Favour of LDCs, and to give effect to the Ministerial Decision on measures concerning the possible negative effects of the reform programme on least developed and net food-importing countries, with a view to enhancing LDC participation in the multilateral trading system, taking into account the impact of trade liberalization, and the relatively weak capacities of LDCs to participate in an increasingly competitive global market in goods and services.

42. Consideration shall be given to further improving GSP schemes and other schemes for products of particular export interest to LDCs, e.g. agricultural products, fish and fish products, leather and footwear, and textiles and clothing, through, where possible, the widening of product coverage, the reduction of procedural complexities, and the avoidance of frequent changes in the schemes. Consideration should also be given to a significant reduction in tariff escalation.

43. The rules set out in the various agreements and instruments and the transitional provisions of the Uruguay Round, including those relating to anti-dumping, countervailing duties, safe-guards and rules of origin, should be applied in a flexible and supportive manner for the least developed countries.

44. As for textiles and clothing, consideration should be given, to the extent possible, to permitting meaningful increases in the possibilities of access for exports from LDCs.

45. In the area of services, efforts should be directed at building and strengthening the efficiency and competitiveness of the weak domestic service sectors of the LDCs. Their participation in trade in services could be enhanced by effective application of Article IV of GATS, with special priority given to LDCs. Furthermore, ways should be explored to facilitate LDC access to information technology and networks and distribution channels, and to give easy access to information to LDC service suppliers through contact points to be established, in accordance with GATS. It was noted that the movement of labour for the provision of services to other countries is an area of interest to LDCs.

46. Care should be taken so that domestic laws and regulations of importing countries in areas such as labour and the environment do not constrain the export opportunities of LDCs in a manner inconsistent with the Final Act of the Uruguay Round.

47. The home countries of foreign investment are urged to encourage investment in LDCs by taking appropriate supportive action.

48. South-South cooperation at the sub-regional and regional levels should be promoted to enhance regional and sub-regional trade by providing market access for LDCs by neighbouring countries. Appropriate measures should be taken to promote, support and strengthen trade initiatives of LDCs in sub-regional and regional groupings. Efforts of the LDCs to diversify their exports need to be supported so that their trading prospects become more viable. Such cooperation can be critical in complementing actions by LDCs and their development partners to attract foreign investment to LDCs. Measures should be taken to grant preferential access to the exports of LDCs on a non-reciprocal basis by developing countries under the GSTP, and also to augment resources, where appropriate, for promoting ECDC and TCDC through multilateral and bilateral institutions. Developing countries should, *inter alia*, introduce preferential schemes for LDCs under the GSTP.

B

49. Technical assistance should be refocused and wherever necessary intensified to help LDCs adapt to and take advantage of the new trading environment created by the conclusion of the Uruguay Round. Common efforts of donors, international organizations and the LDCs themselves are needed in the implementation of the commitments undertaken and for maximizing the opportunities arising from the Uruguay Round agreements. Main areas of technical assistance in this regard should include:

(a) Enhancing institutional and human capacities to comply with the new obligations arising from membership of the World Trade Organization (WTO) or to assist LDCs to accede to the WTO, as well as to formulate and implement future trade policy;

(b) Developing and strengthening supply capabilities in relation to tradeable goods and services, and the competitiveness of enterprises;

(c) Improving the microeconomic trading environment and expanding the use of new communications technologies in the service of trade through the UNCTAD Trade Efficiency programme;

(d) Enhancing the capability to make full use of GSP schemes;

(e) Supporting commodity diversification and marketing efforts;

(f) Expanding the trading and investment opportunities of LDCs, in particular, by identifying new trading opportunities which could be carried out, *inter alia*, through import promotion agencies by developed and other countries, developing an environment conducive to attract foreign investment, and through advice and technical support.

50. With a view to achieving these aims, it is essential to eliminate duplication and strengthen cooperation between relevant international organizations, in particular UNCTAD, WTO and the International Trade Centre UNCTAD/GATT, in order to conserve scarce resources and make full use of the existing and potential synergies among these organizations. Among the measures that should be considered is the establishment of a technical assistance fund administered by the WTO in order to help LDCs participate actively in the WTO.