

Asia-Pacific Least Developed Countries in the next decade: Strategy and policy agenda for building productive capacities

New measures and strategies for the sustainable development of the least developed countries into the next decade should pay special attention to the transformation of their productive capacities – not only to produce more of the same but to produce and trade new and more sophisticated products. Productive capacities can be generated by the process of strategic diversification through the combined efforts of the State and the private sector with a supportive role played by development partners. This Policy Brief outlines a policy agenda for such an effort in the context of the Fourth United Nations Conference on the Least Developed Countries (LDC-IV).

Introduction

For least developed countries (LDCs) in the Asia-Pacific region to climb the rungs of the development ladder, they need to increase their productive capacity. These countries, however, have made little progress on this front in the past 40 years (table 1). Their share of total GDP is less than one tenth of their share of global population and their share of exports has remained lower than 0.25% throughout a period when total world merchandise exports in current terms has increased 42-fold. In addition, they have contributed less than 0.2% of manufactured exports and less than 0.01% of world's high-technology products.

In its *Economic and Social Survey of Asia and the Pacific 2011*,¹ ESCAP argues that, for the least developed countries to build their productive capacity, they must do more than increase the output of existing products; they will instead need to produce and trade new and more sophisticated products.

Patterns of diversification

As economies diversify they tend to export products that are exported by fewer other countries. This will generally mean more exclusive manufactured goods as opposed to more common exports, such as vegetable oils, fish, textiles, garments or mining products. This is illustrated in figure 1. Each country's position on this chart is determined by both

the number of products it exports and their exclusiveness, as indicated by the number of other countries exporting a similar product mix. Countries that fall in the bottom right quadrant are the countries with more diversified production and more exclusive product mixes, with Japan being the most diversified in the Asia-Pacific region, followed by Australia, China and India. Very different, and diagonally opposite, are the LDCs. They have not diversified and continue to produce fairly standard goods.

Figure 2 highlights the situation of the LDCs in Asia-Pacific. Here the Pacific island countries are in the weakest position. For example, Tuvalu and Kiribati each export less than 100 products that are exported on average by more than 110 other countries. To some extent this is a result of their small size. Overall, a 1% increase in population is associated with a 0.3% increase in diversification. Countries with small populations, therefore, face an inherent disadvantage in their process of diversification.

Countries wishing to diversify can anticipate competition. Between 1984 and 2009, average diversification rose from 968 to 1,868 products; while the average number of countries exporting a similar product mix increased from 41 to 91. Given this trend, countries that do not diversify are likely to fall behind.

In addition, the process of diversification is path dependent: products that a country produces today affect those it will be

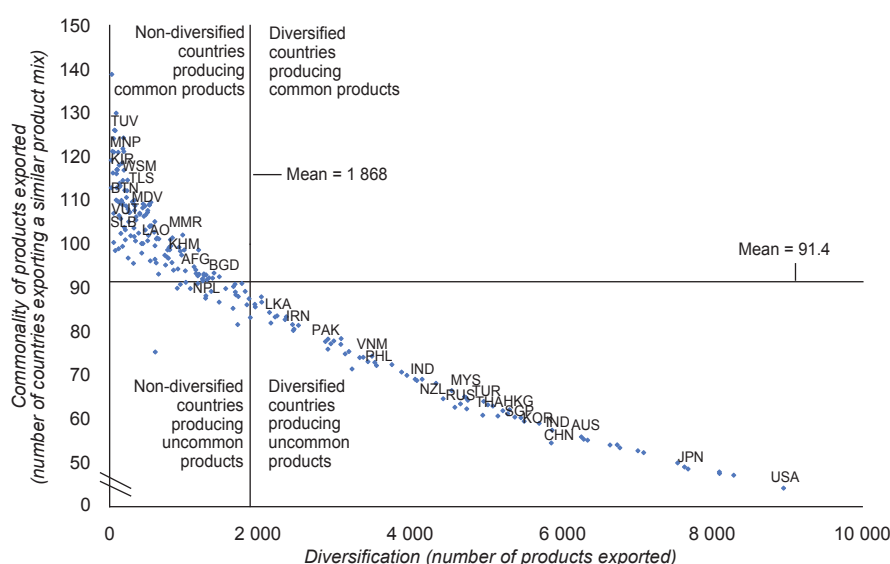
Table 1. Share of Asia-Pacific least developed countries in international production and trade

(Percentage)

Indicator	1970	1980	1990	2000	2007	2008	2009
Population	3.18	3.21	3.44	3.65	3.83	3.78	3.86
GDP	0.43	0.22	0.18	0.22	0.23	0.24	0.25
Manufacturing, value added	0.60	0.14	0.16	0.16	0.20	0.31	0.58
Merchandise exports	0.11	0.12	0.09	0.17	0.19	0.19	0.24
Manufactured exports	0.01	0.06	0.07	0.16	0.12	0.04	0.01
High-technology exports	0.00	0.00	0.01	0.00	..

Source: ESCAP, based on data from the World Bank.

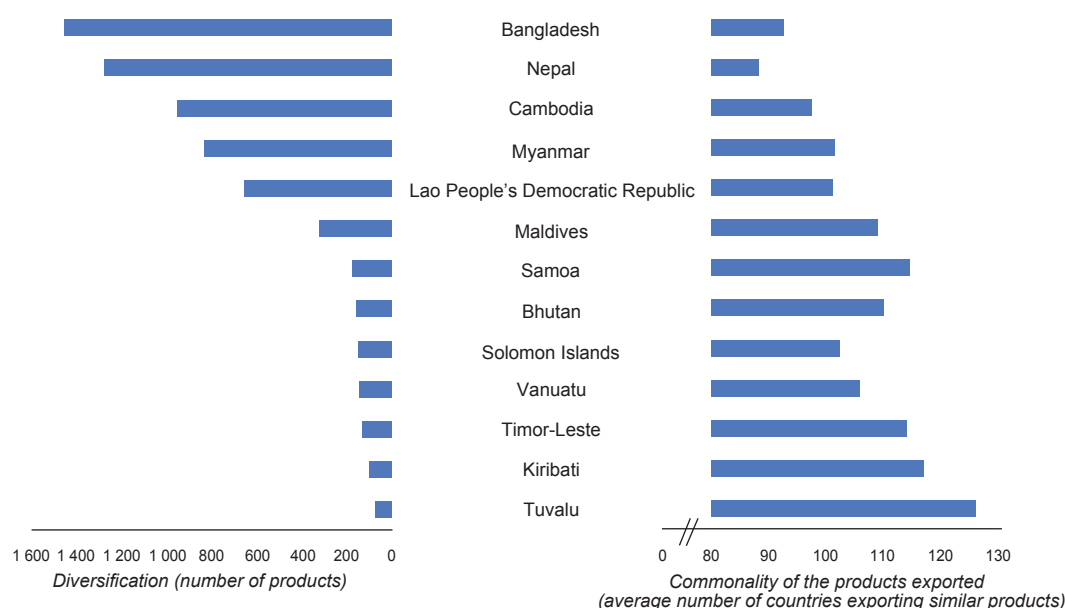
Figure 1. As countries diversify, they produce more exclusive products



Source: ESCAP, based on data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

Note: Products are originally classified using five-digit SITC, Rev.2 classifications. Products under the same five-digit classification are further differentiated based on their unit value. See Freire (2011) for details.ⁱⁱ

Figure 2. Diversification in the least developed countries



Source: ESCAP, based on trade data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

able to produce tomorrow. As a result, diversifying towards some products would increase the range of possibilities for further diversification. Based on market forces alone, however, LDCs often do not diversify along the path that will bring them the highest possible future returns.

Assessing productive capacities

If a country is to consider how best to diversify, it will need to assess its current productive capacity. For this purpose, it might consider, for example, current levels of technology, education and skills, along with policies, regulations and infrastructure, as well as how all of these things are related. This is a daunting task.

An alternative, however, is to focus not on the possible components of the productive capacity but on its result—the actual production. The assumption is that the fewest capabilities will be found in the countries that are the least diversified and whose product mixes are similar to those of many other countries. ESCAP has used this information on diversification to arrive at a “productive capacity index”.

The results for Asia-Pacific countries are indicated in figure 3, in which each country is compared with the global mean. It shows that most countries in the region are below the global average. Other things being equal, the greatest productive capacities, which lead to higher GDP, are found in countries with larger populations. This,

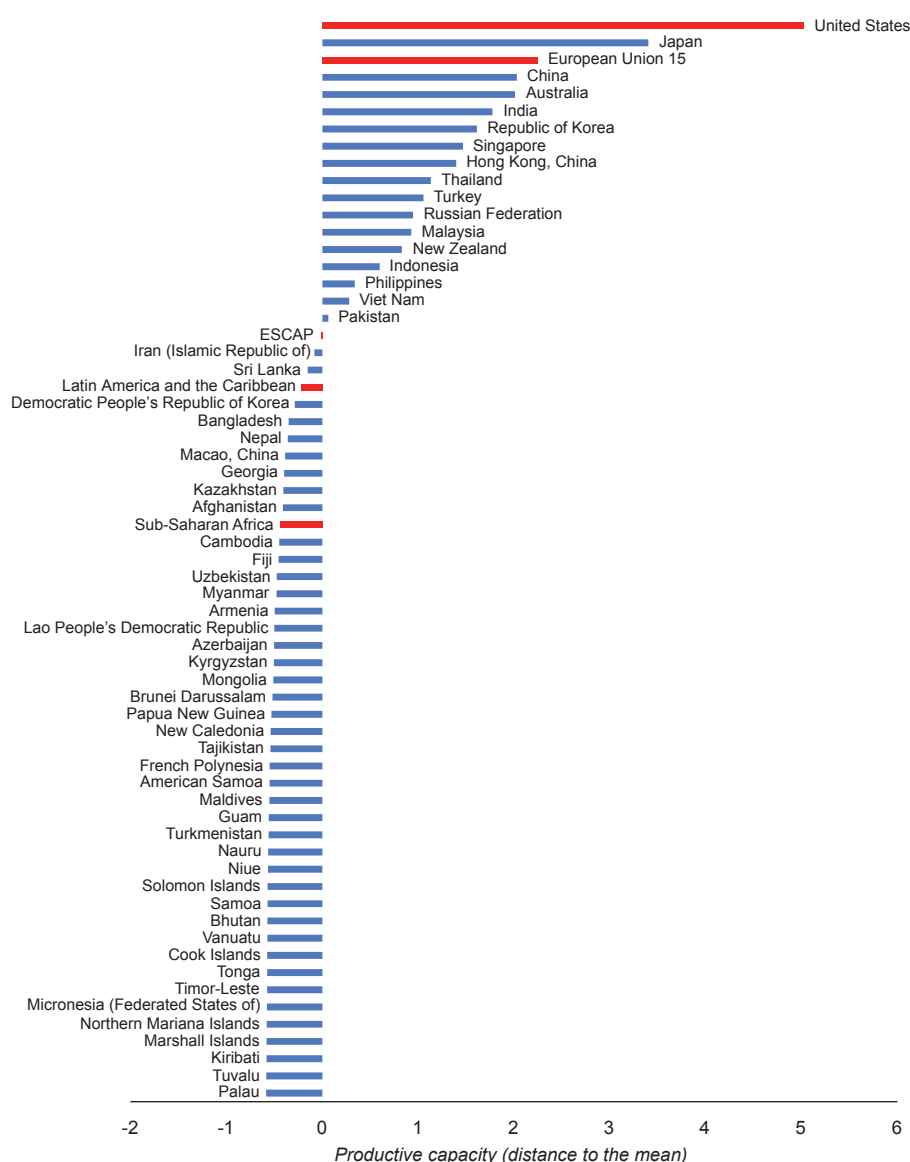
however, does not necessarily translate into higher standards of living. Singapore, for example, has a lower productive capacity than the United States, but it has a similar GDP per capita, and it also has a comparable standard of living. Developing countries do not, therefore, need to aim for a productive capacity that is above average but rather for one that will allow them to reach a GDP per capita similar to that of developed countries.

The Asia-Pacific LDCs have not made much progress over the years, as is depicted for the period 1991-2009 in figure 4, which shows the level of productive capacity in each country compared with the global mean over time. Bangladesh and Nepal have held their positions while all the other countries, despite recent rises, have generally lost ground; not because they have lost productive capacity but because they have progressed more slowly than others. That highlights the special circumstances that these countries face and the need for targeted assistance and strategies for the improvement of their productive capacities.

Graduating from the least developed country status

How can LDCs sufficiently increase their productive capacity and produce a wider range of goods and services? The prospect is not as daunting as it might seem since these countries do not need to aim for an above-average productive capacity to boost their GDP per capita above the threshold required to graduate from least developed country status. Table 2 presents estimates of the increase in the number of products that the less populated, and less diversified, LDCs would need in order to graduate. For example, Bhutan exported 158 categories of products in 2009, and to graduate from least developed country status, it would need to increase that number to 260. This is a sizeable increase, but by no means impossible; this total number has already been reached by some other small developing economies, such as the Central African Republic, Grenada and Guam.

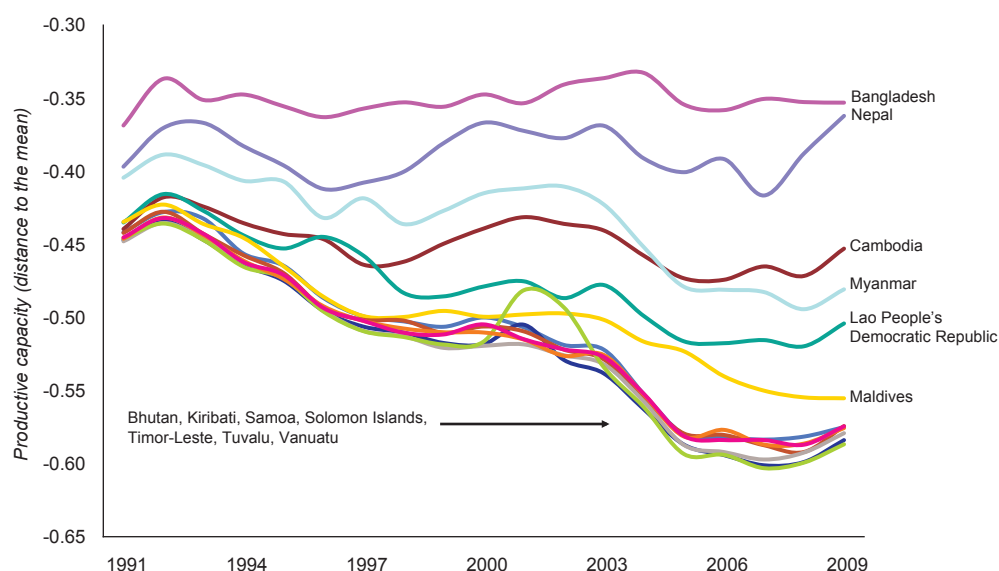
Figure 3. Productive capacity of countries in Asia and the Pacific, compared with the global mean, 2009



Source: ESCAP, based on trade data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

Notes: The unit of measurement is the standard deviation of the distribution of productive capacities. See Freire (2011) for details.

Figure 4. Evolution of average productive capacity, 1991-2009, Asia-Pacific least developed countries



Source: ESCAP, based on trade data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

Notes: The unit of measurement is the standard deviation of the distribution of productive capacities. See Freire (2011) for details.

It should also be emphasized that small LDCs can boost their per capita GDPs, and thus their prospects to graduate from least developed country status, by expanding tourism and other services. In fact, the only two countries that have graduated so far – Botswana and Cape Verde – have taken different paths (figure 5). Botswana does have a higher productive capacity – mainly due to diversification within the mining industry, but Cape Verde has had a capacity trajectory similar to that of less populated Asia-Pacific LDCs. It was able to graduate largely by boosting tourism, from less than 6% in 1995 to 28% of its GDP in 2008. Analysis suggests that, after controlling for population size and the level of productive capacity a 1% increase in tourism revenue increases the total output of a country by around 0.25%. The two Asia-Pacific countries already recommended for graduation could follow a similar path. For the Maldives, which graduated in January 2011, tourism makes up 50% of GDP. For Samoa, which is set to graduate in 2014, tourism makes up 21% of GDP.

Tourism can and does promote development in less populated countries. In the long run, however, an increase

in productive capacity and the associated increase in diversification through the production of more complex goods is the most viable way to attain sustainable development in all countries, regardless of their size. For less populated LDCs to reduce their economic vulnerability and promote sustainable development, they ultimately have to steer their development towards enhancement of their production capabilities.

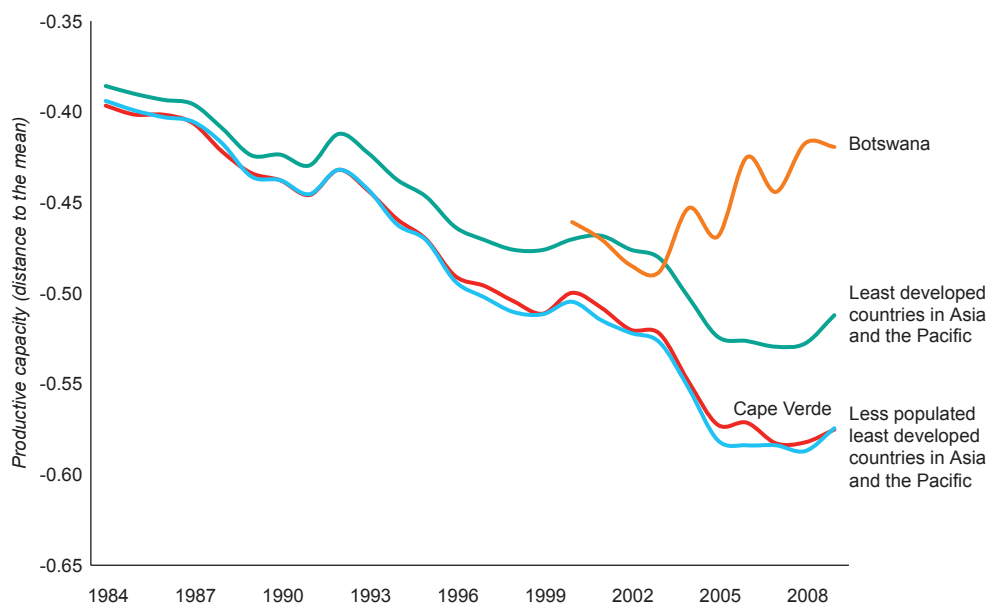
Greater regional integration can help in this process. Over the past two decades, as globalization has intensified, the region has been redirecting its output to the rest of the world. Between 1984 and 2008, the productive capacity that the region directed exclusively to itself fell from 40% to 14%, while that used to service exports both within and beyond the region rose from 22% to 48%. Although the outside market is undoubtedly very important for the sustainability of current levels of productive capacity of the economies in the region, the intraregional market is the one that generally provides the opportunities for product upgrades that lead to the production of more complex products; serving as a training ground for exporting to the rest of the world. Therefore, regional integration that

Table 2. Estimates of diversification required to graduate from least developed country status, 2009

Country	Current number of products	Number of products required	Percentage increase required	Countries with diversification similar to the desired level
Bhutan	158	260	64	Central African Republic, Grenada, Guam
Kiribati	99	210	112	Rwanda, Somalia
Solomon Islands	149	330	121	Bermuda, Maldives
Timor-Leste	133	470	253	Guyana, Suriname, Togo
Tuvalu	75	100	33	Montserrat, Northern Mariana Islands
Vanuatu	146	220	50	Eritrea, Nauru, Turks and Caicos Islands

Source: ESCAP, based on trade data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

Figure 5. Evolution of productive capacity: Asia-Pacific least developed countries and other graduating countries, 1984-2009



Source: ESCAP, based on trade data from the United Nations Commodity Trade Statistics Database (COMTRADE). Available from <http://comtrade.un.org/db/default.aspx> (accessed November 2010).

facilitates intraregional trade has the potential to increase the productive capacities of the LDCs in the region.

Strategy for increasing LDCs' productive capacities

The increase in productive capacities is not a matter of the efficient exploitation of the existing comparative advantages. Economies build their productive capacities through a path-dependent diversification process that expands their production bases by including products that are increasingly more complex, thus facilitating even further diversification in the future. Therefore, a pragmatic strategy for LDCs to build their productive capacities is to let these capacities be generated as part of the process of such strategic diversification through the combined efforts of the State and the private sector.

Such strategy comprises three main processes that, when set in motion, can act as an algorithm for discovering, acquiring and spreading the productive capacities required for developing economies to catch up to more developed economies.

Differentiation

During the differentiation process, possible new economic activities are explored. This process is the same as product innovation—the production of new products—as opposed to process innovation, in which the use of new technologies (physical or managerial) is employed to increase the scale of the production of existing products.

The State and the private sector should jointly identify a strategic direction for differentiation. Without a strategic direction, differentiation may lead to products that are less complex or to products that, although more complex, do not serve as an easy platform for further diversification in the future, in which case the short-term progress will be doomed to grind to a halt.

Each economy can estimate this potential for innovation by comparing its existing output with that of other economies producing similar products. This suggests that each of the Asia-Pacific LDCs could gradually produce about 400 new products closely related to existing ones. Only around 10% to 15% of them, however, would be both more complex and better connected to other products, thereby helping the country move forward and position itself for future innovation. It is therefore important to focus on those products which yield the highest social benefit.

A pragmatic way to look for new products is by emulating the production pattern of countries that have higher productive capacities, even if they do not have higher per capita GDPs. Bhutan, for example, might look to India, which has a lower per capita GDP but is producing a more diverse range of goods. Ideally, the country to be followed should not be too far ahead so that emulating it does not entail too great a leap.

New products could also replace some of the current imports of the country. Products that are imported, if they have levels of complexity similar to the products domestically produced, show the frontier of possibilities available for the use of the productive capacities that domestic firms already have. That increases the chances for new combinations of the productive capacities, replacing some of the imports or creating new products altogether. Trade decreases the cost of discovering such possibilities.

In the process of differentiation, other factors should be taken into consideration, such as the potential for employment creation in the new economic activities and the ecological sustainability of the production process. It is important for the State to lead the process, to function as a catalyst that facilitates the interests of new businesses to overcome the expected resistance to change of traditional businesses.

The implementation of such strategic differentiation requires the selective promotion of certain economic activities over others through the use of industrial policy. In this case, the policy would promote new economic activities/products that are more complex and allow for further diversification in the future, regardless of whether they are located within industry or manufacturing, per se.

Selection

As in any entrepreneurial venture, some of these new activities will fail. Ideally, clear benchmarks for success should be set and the market is invariably in a better position than the State to establish them. A pragmatic measure of success is progress in foreign markets, which was the measure used by East Asian countries during their industrialization process. In the case of import-substituting products, though, the State needs a sunset plan for the removal of protection. An important element of the selection process is choosing the time frame for the assessment of performance. The greater the jump in complexity from existing to new products, the longer it will take the private sector and the State to acquire the necessary capabilities.

Amplification

New production need to be promoted and replicated by attracting sufficient capital. The aim is not to scale up particular firms but to facilitate the replication of successful business models by many other firms. Amplification will also depend on sufficient demand, which may constitute a challenge if the country is too small or too poor. One option for small developing economies is for them to pool their demand by providing preferential access to other small economies. Economies in the South usually import many goods from the North that are available, under competitive conditions, in other developing economies.

The three processes described above should be put into perpetual motion for LDCs to catch up with the frontier countries. In this process, it is essential to strengthen national institutions and good governance in order to provide a stable environment for the evolution of the economy, the curbing of capitalist cronyism and the promotion of development goals.

and stable inflation, and sustainable domestic and external imbalances.

Countries need to utilize the full scope of appropriate countercyclical policies to maintain economic and financial stability in the face of domestic and external shocks to avoid abrupt economic fluctuations. The international community and the G20 should aim to assist LDCs in their development processes by providing a stable and benign external environment for development and by fostering the flow of long-term development financing.

Industrial policy and infrastructure development

Active public intervention is required to create infrastructure, including industrial estates and economic zones, capacity-building in entrepreneurship development, support services to small and medium-sized enterprises (SMEs) in technology, marketing and export market development and other promotional measures that are covered under industrial policy. An important aspect of industrial policy has been infant industry protection provided to domestic industry in the early stages of development. Infant industry protection was extensively employed as a policy tool by most developed countries and newly industrialized countries in the early stages of their development. Least developed countries have every right to use infant industry protection to diversify their productive capacities in new areas and provide fledgling productive capacities some space to grow.

Public investment could play a proactive role in infrastructure development and act as a catalyst for public-private partnerships by creating a virtuous cycle of investment and spurring inclusive growth. For that reason, countries need to implement fiscal and tax reforms, improve budgetary processes, improve the quality of public expenditure, promote financial inclusion through creative monetary policies and enhance the transparency of public financial management.

Domestic resource mobilization and financial institutions

Least developed countries need to foster a diversified, well-regulated and inclusive financial system that promotes

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