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Contribution and effective use of external resources for development, in particular for productive capacity-building

Issues paper prepared by the UNCTAD secretariat

Executive summary

UNCTAD-XII, held in Accra, Ghana, in April 2008, recognized that monetary and financial stability at the national and international level and crisis prevention were important for sustainable development and growth. The Conference also emphasized that further cooperation among development partners and relevant international institutions could improve country ownership, more closely align external resources to national development priorities and enhance mutual accountability. In addition, the Conference noted the development of domestic productive capacity was essential for effective use of foreign direct investment (FDI) and for overall economic development. UNCTAD-XII also affirmed that all developing countries, in particular the least developed, had to build productive capacity to ensure optimal use of external resources for development. Since then, the World Conference on the World Financial and Economic Crisis and Its Impact on Development committed to a coordinated and comprehensive global response to the crisis.

In the context of these mandates, this issues paper explores how the interaction of the key components of external resources for development can enhance productive capacity. It is intended to assist with deliberations of experts from governments, academia, international organizations and UNCTAD on how developing countries can better respond to the challenge of mobilization and effective management of external resources focused on productive capacity-building. In particular, the paper highlights the role of macroeconomic policies, official development assistance (ODA), external debt and the contribution of FDI.

Introduction

1. The Trade and Development Board, at its forty-seventh executive session, held on 30 June 2009, approved the following topic for a single-year expert meeting: "Contribution and effective use of external resources for development, in particular for productive capacity-building".

2. In December 2008, in Doha, Qatar, Heads of State and Government and High Representatives reviewed progress made since the 2002 International Conference on Financing for Development, held in Monterrey, Mexico. They reiterated, inter alia, their resolve to take concrete action to implement the Monterrey Consensus and address the challenges of financing for development. They also recognized that mobilizing financial resources for development and the effective use of all those resources were central to the global partnership for sustainable development, including in support of the achievement of the internationally agreed development goals. This Issues paper examines the enduring and emerging features of external resource flows to developing countries, in particular the impact of global capital flows, aid, debt and foreign direct investment on the building of productive capacity that can sustain growth and development.

I. Capital flows uphill: implications for macroeconomic policies and development strategies

3. In the late 1990s, the current account of developed countries as a group moved from a surplus to a deficit and developing economies as a group moved from a deficit to a large surplus. The magnitude of this new phenomenon of "capital flowing uphill" has caused some observers to conclude that some developing countries have been creating a global "savings glut" in contrast with expectations derived from standard growth theories. This is against mainstream theory, which suggests that with open capital markets, capital will flow from rich to poor countries in order to exploit the higher expected rates of return on capital and bridge the "savings gap" in capital-scarce countries. Net capital-exporting developing countries also tend to grow faster and invest more than those developing countries that receive net capital inflows. This calls into question another hypothesis of standard economic theory, namely that there is a close and positive relationship between capital account liberalization and economic growth.

4. Higher commodity prices and better terms of trade have greatly contributed to improving the current-account balances of some developing countries in recent years. Another factor, at least equally important, has been the fast growth of exports of manufactures of a number of developing countries based on rapid productivity growth and favourable real exchange rates. The evolution of the aggregate current-account balance is strongly influenced by the behaviour of the two largest economies in each group, the United States and China respectively. The reversal of the current-account balances of developing countries started around 1998, largely in response to the wave of financial crises that hit the developing world in the second half of the 1990s. The reversal was driven mainly by emerging-market economies. Within a decade, the emerging-market economies among the developing countries had largely eliminated their current-account deficits, while other developing countries continued to maintain a substantial deficit.

5. Evidence has shown that in countries which are heavily dependent on primary commodities, swings in the current account are driven to a large extent by changes in commodity prices, and that in countries with more diversified export and production structures, the real exchange rate plays the key role in determining changes in the current-account balance. Large improvements in the current account are usually accompanied by

either a positive terms-of-trade shock or by a depreciation of the real exchange rate, and the subsequent improvement in the current-account balance enables implementation of a more investment and growth-friendly monetary policy stance.

6. Changes in the current account are influenced by a variety of factors in addition to the real exchange rate and the terms of trade: current-account reversals in developing and transition economies are negatively correlated with GDP growth in developed economies. External financial shocks (as measured by changes in the United States interest rate policy), have practically no effect on the probability of a current-account reversal of developing countries with a closed capital account -- but for countries with an open capital account, it can have a large positive effect. Hence, rather than being driven by autonomous saving and investment decisions of domestic agents, current-account reversals in developing countries tend to be driven by external shocks emerging from goods as well as financial markets.

7. The fact that a number of developing countries are rapidly accumulating foreign exchange reserves, instead of using these funds to consume more imports, reflects attempts to defend their favourable competitive position arising from an undervalued exchange rate - mostly reached after a severe financial crisis. It also arises from their strategy to avoid dependence on the international capital markets and their volatility. It is only under such circumstances that open developing economies are able to set their monetary conditions in a way that favours domestic investment and the building of productive capacity. One crucial element is the availability of adequate, reliable and cost-effective financing of investment.

8. These reverse capital flows have been considered theoretical “paradoxes”, but they are no longer puzzling if one recognizes the limitations of the underlying theories: the savings gap model and the neoclassical growth model. These models are based on the assumption that investment is financed from a savings pool created mainly by household savings. Accordingly, entrepreneurial investment will be maximized by policies aimed at increasing household savings rates and capital imports (“foreign savings”), and improving the efficiency of financial intermediation by developing a competitive financial system and creating securities markets. Not only are the assumptions of these models far from reality, but also their predictions have been repeatedly refuted by empirical evidence. For example, many developing countries, particularly in Latin America, failed to achieve higher productive investment despite monetary and financial policies that attracted waves of capital inflows.

9. An alternative view is based on the work of Schumpeter and Keynes, and deriving from the experiences of post-war Western Europe and the successful catching-up experiences in East Asia. This emphasizes that the financing of investment depends primarily on savings from corporate profits and the possibility of the banking system to create credit. Strong enterprise profits simultaneously increase the incentive of firms to invest and their capacity to finance new investments from retained earnings. This view better reflects the complexity and imperfections of the real world, where entrepreneurial profits immediately adjust to changes in demand, and entrepreneurial decisions based on profit expectations (rather than the level of savings) determine the level of investment in productive capital.

10. For example, a fall in the savings ratio does not lead to a fall in investment; on the contrary, since it implies an increase in consumer demand, it will increase profits and stimulate investment. By the same token, an improvement of the current account as a result of changes in relative prices in favour of domestic producers does not represent a reduction in the inflows of foreign savings that causes a fall in investment; on the contrary, it is equivalent to an increase in aggregate demand and in the profits of domestic producers, and tends to lead to higher investment. Thus, an increase in savings is not a prerequisite for either higher investment or an improvement in the current account. Rather, the causality

works in the opposite direction: changes in the current account lead to changes in the level of investment and savings.

11. The consequences of the different theoretical approaches for economic policy could not be more different. When investment, output growth and employment are determined largely by profits of enterprises, economic policies have an important role to play in absorbing shocks and providing a stable environment for investment. By contrast, in the neoclassical model there is little room for economic policy, and where it offers economic policy options, they often point in the opposite direction. Where the neoclassical model sees the need for private households "to put aside more money" or for developing countries to attract more "foreign savings" to raise investment in fixed capital, the alternative model emphasizes positive demand and profit expectations as incentives for domestic entrepreneurs, and the need for reliable and affordable financing for enterprises.

12. Monetary instability, periods of hyperinflation and frequent financial crises have often forced many developing countries to adopt economic policies that generate the exact opposite of what would be favourable investment conditions. "Sound macroeconomic policies" as prescribed by the Washington Consensus, combined with financial liberalization, seldom led to the desired result of higher investment and faster growth, whereas the alternative policy approaches helped the newly industrializing economies of East and South-East Asia to accelerate their catch-up process. To be sure, a stable environment conducive to investment in productive capacity must include price stability. Countries that are prone to high and accelerating inflation may find it more difficult to start and sustain a process of development and catching up than countries with a history of price stability. But appropriate wage and incomes policies could help countries to maintain price stability so that monetary policy can be used to support an investment-led development process without risking an acceleration of inflation.

13. However, there is a risk that governments will use exchange-rate manipulation in the same way as wage compression, subsidies and lower corporate taxation to artificially improve the international competitiveness of domestic producers. This "neo- mercantilism" in the competition for higher market shares cannot achieve the desired results. This is because, while all countries can simultaneously boost productivity, wages and trade to improve their overall economic welfare, all of them cannot simultaneously increase their market shares or their current-account surpluses. Successive rounds of competitive devaluations are therefore unproductive and likely to cause considerable damage.

14. Strengthened international cooperation in macroeconomic and financial policy may be required to contain speculative capital flows and reduce their damaging impact on the stability of the world economy. Such cooperation could also help prevent governments from manipulating exchange rates to improve the international competitiveness of their economies. A framework of international rules governing international monetary and financial relations similar to those governing the use of trade policy measures in agreements of WTO could lend greater coherence to the system of global economic governance. The adoption of such a code of conduct would mark a new spirit of multilateralism in global economic governance and would allow balancing the potential advantages resulting from real exchange rate adjustment for one country against the potential disadvantages of other countries that would be affected by that adjustment.

II. Official development assistance: securing growth towards 2015 and beyond

15. Another aspect of investment financing in support of diversification and structural change in developing countries is their foreign exchange requirement for imports of capital

goods. This is a problem in particular for poor commodity-dependent economies, which typically rely on official loans and grants from bilateral and multilateral donors. Following the Monterrey Consensus of 2002, most bilateral donors providing official development assistance (ODA) set ambitious targets for increasing their ODA as part of efforts to meet the MDGs. But despite a substantial increase in disbursements, most donors are not on track to meet their ODA pledges. Moreover, there is still a considerable gap between actual ODA flows and the aid estimated to be necessary for implementing measures in pursuit of the MDGs.

16. ODA by DAC (Development Assistance Committee) donors rose to its highest level in 2008 to its highest dollar figure of $119.8 billion, reaching 0.3 per cent DAC donors' total GNI, about 7 per cent of which consisted of debt relief. It is possible that this increase in ODA still reflects decisions taken during the previous period of high and stable economic growth in donor countries and that the ODA may be negatively affected by the current crisis. OECD estimates suggest that donors will need to increase current ODA expenditures by $10 to 15 billion to meet their aid commitments for 2010; but aid targets may fall short of the additional development resources needed to respond to the challenges posed by the global crisis. Aid will have an important role to play in providing much needed counter cyclical resources and help governments to support social expenditure and expand infrastructure.

17. It is now widely accepted that the global economic crisis can be tackled only through coordinated responses that involve not just developed but also emerging, transition and developing economies. For the latter, foreign aid provides the main, and in some cases the only, source of the financing needed to prevent their sliding into deep recession and losing their hard-earned productive and exporting capacities. For these countries, the kind of stimulus package that more advanced nations are able to offer themselves is simply out of reach. But their economic survival depends on keeping demand healthy. And given the extent of global interdependence today, maintaining aid commitments and stabilizing aid flows will do much more than help recipient countries: it will also help stabilize global demand, which is in everyone's interest.

18. With the commitment of the international community since 2000 to make achievement of the MDGs a common project, the general rationale for ODA shifted from an historical focus on economic growth as a precondition for realization of social objectives, to attainment of the social, human and environmental objectives themselves. Given that ODA fell dramatically between 1993 and 1999, average ODA per capita, in real terms, since the beginning of the new millennium has not been much higher than it was in the 1960s and 1980s, notwithstanding the recovery since 2000.

19. There is broad agreement among donors and beneficiaries that it is not only the amount of ODA that matters, but also how effectively the funds from donors are being used. Since the mid-1990s, conditionality has focused more on the design and implementation of poverty reduction strategies, with greater attention given to the social implications of development policies. However, poverty reduction strategies typically are to be combined with macroeconomic policies and structural reforms that strongly resemble the prescriptions of previous structural adjustment programmes.

20. Improved aid effectiveness has been also increasingly associated with better institutions and policies. While there is general agreement that improvements in governance and institutions are desirable in their own right, and are often positively correlated with economic development, there are different interpretations of the empirical evidence regarding this relationship, including the direction of causality. Although views differ as to what constitutes good institutions and policies, and despite weak evidence that such a correlation actually exists, the provision of ODA has increasingly become conditional on fulfilling numerous criteria of good governance.

21. Aid effectiveness is also often viewed in relation to procedures for implementing it. In this regard, aid management policies that enhance mutual accountability of donors and recipient governments could help reduce transaction costs and strengthen States' capacities for effective use of foreign aid. But equally important is the development effectiveness of the aid resources provided by donors. In determining a yardstick for such effectiveness, it is useful to distinguish between social and human development objectives on the one hand, and growth objectives on the other.

22. Traditionally, the objective of ODA has been per capita income growth, with attendant effects on human development. With the Millennium Declaration, human development objectives have come to the forefront. Meanwhile growth has lost prominence as an explicit objective of development policy in a policy environment governed by the implicit assumption that, in a liberalized and globalizing economy, growth and structural change are generated automatically by market forces. Accordingly, aid effectiveness is increasingly viewed in terms of the contribution of ODA to the achievement of the MDGs.

23. This kind of ODA is essential and justified in its own right. However, for poverty reduction to be sustainable it cannot rely exclusively on the redistribution of a given income; it also depends on increases in domestic value added and per capita incomes. The developmental role of aid, in the form of enhancing productive capacity, creating employment, increasing domestic value added and contributing to structural change risks being neglected. Moreover, unless ODA is effective in helping growth, it is unlikely to be effective in reducing poverty in the long-term beyond 2015. Therefore, in order to achieve sustained poverty reduction, increases in ODA for social infrastructure and services must be accompanied by increases in ODA for economic infrastructure and productive sectors. Further increases in ODA for social infrastructure and services must therefore not be at the expense of ODA for economic infrastructure and productive sectors

24. Another way to increase ODA effectiveness is to leverage ODA with domestic financing. For example, this may be done through the creation or strengthening of institutions that would channel ODA into public and private investment projects financed jointly with domestic financial institutions. This could facilitate access of potential domestic investors to long-term financing and reduce the credit risk of domestic banks – and thus the spreads they charge. At the same time it would help to build a better functioning system of domestic financial intermediation.

25. In the past, the relative needs of countries, which could be measured by levels of per capita income and human development indicators, or the degree of their fiscal or foreign-exchange gap, only had a limited influence on the geographical distribution of ODA. Yet aid effectiveness could be improved by directing further increases in ODA grants to the poorest countries that have the greatest difficulty in initiating a self-sustaining process of investment and growth.

26. Furthermore, UNCTAD analysis shows that within the category of sectoral ODA, flows targeted at economic infrastructure contribute strongly to economic growth, whereas those earmarked for social infrastructure and services do not. These findings have important policy implications for financing of the MDGs and for development in general. While aid for social sectors is welcome, and should even be intensified in certain areas or regions, such disbursements should come in addition to sectoral ODA in support of capital formation in the productive sectors.

27. If ODA recovers from the present crisis as slowly as it did in the wake of previous financial crises – say, three to four years hence, just when world markets are beginning to pick themselves up again – developing countries will be caught short, lacking the productive capacity they need to take advantage of reviving opportunities. Since some donors set their aid targets as a percentage of GDP, a drop in GDP could lead to a drop in

aid. Moreover, aid budgets are usually fixed in domestic currency; and if that currency depreciates against the recipient's currency, the value of the aid budget in the recipient currency will decrease as well.

28. This dire situation cannot be addressed through worn-out remedies. New thinking will be needed – and indeed, several innovative proposals are already on the drawing board or in the trial stages, including a currency transaction tax, global lotteries, vulnerability funds, subsidized investment funds for developing countries, and markets targeting ethical investors. Another solution proposed by UNCTAD would be to create safe, ODA-specific endowments funded by the interest on the assets. The endowment model has worked repeatedly well for educational institutions, and could similarly fulfil the critical need for predictable ODA flows.

29. Predictability has generally not been assured thus far, because aid budgets, like other government budget lines, are subject to annual or pluri-annual decision-making processes. If aid agencies were instead provided with an endowment, and their activities funded through the interest earned on principal, this would give them a degree of independence and help stabilize the global economy. In order to eliminate debt roll-over problems this endowment could be created by issuing government consols ("consolidated annuities"; i.e., government bonds with no maturity date). The aid agency could then use the interest revenues from the consols to fund its activities – but would be prohibited from using the capital.

III. Ensuring debt sustainability in the wake of the crisis

30. Developing countries as a group registered a shrinking current account surplus that had dropped to 2.5 per cent by 2008 and is expected to shrink further to 1.6 per cent in 2009. In 2007, about 40 per cent of all developing countries had a current account deficit greater than 6 per cent of GNI; by 2008 the share of developing countries with large current account deficits had risen to 53 per cent. Financing these current account deficits may become problematic for some developing countries. Preliminary data indicates a 50 per cent reduction in net private capital flows to developing countries in 2008 and further reduction in 2009. This "reversal of international capital flows", should not be regarded a priori as a curse for all affected countries. While many low-income countries do need external resources to finance productive imports, in many market-access countries private flows are often driven by speculative behaviour and end up in overvaluation of the currency and consumption booms. There are thus cases in which the reversal in private capital flows may have a minor effect on GDP growth and even help the affected countries to move towards a more sustainable growth model.

31. For much of the past year, countries that tap the international capital markets faced higher borrowing costs driven by the global increase in risk aversion, though borrowing costs have been coming down recently. This volatility of borrowing costs may endanger the solvency of private borrowers based in emerging markets as a large share of their external debt contracted during the period 2003-2007 is now coming due. In most cases, high borrowing costs are not justified by deteriorating fundamentals but are the result of the general "risk aversion" that was triggered by a shock originating elsewhere. The same markets that had shown "confidence" in the policies of developing and transition economies by appreciating the currencies of these economies suddenly turn around and flee these markets as if economic policy had changed dramatically.

32. Lower economic growth and higher financing costs are likely to cause a deterioration of the external debt situation of developing and transition economies. Thanks to prudent policies implemented during the last 5 years, many middle income countries are

endowed with large war chests of reserves. They are thus well equipped to face one or two years of tight capital markets. The situation is different for several low-income countries which are close to running out of reserves, or already have. Countries with liquidity problems have been able to access stepped-up IMF resources. However, if the current conditions persist beyond 2009, several countries are likely to start facing serious liquidity and solvency problems.

33. Many low-income countries are on the brink of a balance of payments crisis brought about by terms of trade shocks, decline in export demand, and reduction in tourism and remittance flows. Several Highly Indebted Poor Countries (HIPCs) are affected by the global economic and financial crisis through a number of channels. Completion-point countries are facing an average current account deficit of 8 per cent of GNI and the average current account deficit of decision point and pre-decision point countries exceeds 10 per cent of GNI. This highlights the need for highly concessional or grant based external financing for all HIPCs, including post-completion point countries.

34. Meanwhile, the development and deepening of financial markets and financial reform policies have enhanced access to the international capital markets by private borrowers from developing countries. In the early 1990s, less than 10 per cent of total external long-term debt issued by developing countries was owed by private borrowers and most foreign borrowing was done by the public sector. Over the last 15 years, private firms and banks have been drawing finance from international markets in increasingly larger amounts. As a consequence, the share of total external long-term debt owed by private borrowers reached 50 per cent by 2008.

35. The fact that private sector entities are now able to access the international capital market diminishes the traditional role of the state as an intermediary for such financing. It has been argued that since private agents are better equipped at evaluating the risk of their actions, private external borrowing does not lead to vulnerabilities as long as the fiscal accounts are balanced. This view was discredited by several debt crises, which hit countries with high private investment rates and balanced fiscal accounts. Therefore, the fact that a country has a large share of its external debt owed by private borrowers should not be interpreted as an indication of lower vulnerabilities.

36. There are conditions under which private external debt may lead to over borrowing and generate more vulnerabilities than public sector external debt. Large inflows of private capital can lead to overvaluation, with the concomitant loss of competitiveness and unsustainable current account deficit. Moreover, private external debt often leads to the accumulation of currency mismatches in the balance sheets of firms and households. Such difficulties are amplified by the fact that private agents often assume currency risk by using sophisticated derivative instruments. Policies aimed at developing domestic bond markets may enable corporations to avoid excessive external exposure. But developing countries need to be careful to avoid policies that could increase financial instability by facilitating inflows and outflows of hot money.

37. The G20 and International Monetary and Financial Committee (IMFC) communiqués of April 2009 requested a revision of the IMF/World Bank Debt Sustainability Framework (DSF) for low-income countries with the objective of enhancing the flexibility of the Framework. The current version of the DSF uses explicit limits on the net present value of external debt, above which external debt is considered unsustainable. There are serious issues on how these thresholds are calculated and how they relate to the World Bank's Country Policies and Institutional Assessment (CPIA) index. The World Bank and IMF are elaborating a proposal aimed at addressing some of the issues raised by critics of the DSF, but it appears that the CPIA will remain central to calculating debt thresholds.

38. The DSF does not make any distinction between debt used to finance investment projects and debt used to finance current expenditure. This is problematic because investment projects can increase GNI growth and thus improve a country's ability to service its debt. A more flexible DSF which allows for higher debt thresholds when external borrowing is used to finance high-return investment projects would be desirable as it would recognize that not every increase in debt leads to a reduction in government wealth. Moreover, as current expenditure tends to be the most rigid component of the government budget and investment is the typical adjustment variable when the debt exceeds the threshold fixed by the DSF, adding flexibility to the DSF may contribute to reducing the volatility of public investment in developing countries.

39. In increasing the flexibility of the DSF, it is necessary to recognize that financing investment projects that generate returns which are higher than the interest rate charged on the loan is a necessary but not sufficient condition for external sustainability. Only projects that have a high return and can, either directly or indirectly, generate the foreign currency necessary to service the debt will not harm external sustainability.

40. An additional issue relates to debt composition that recent research has shown to be as important as debt levels in determining debt sustainability. The DSF should be revised and expanded to include both domestic and foreign debt and control for debt structure by giving different weights to different types of debt. For instance, all other things being equal, long-term debt denominated in domestic currency generates less vulnerabilities than short-term debt denominated in foreign currency. The recent discussion in the IMF Executive Board on building debt thresholds that consider the currency-denomination of domestic debt is a welcome step in the right direction.

41. Developing countries are paying a steep price for an economic crisis caused by policy and regulatory mistakes of some developed countries. Prevention of future crises will require more even handed surveillance of all major financial centres. Decisive and bold policy action is required to limit the setbacks in terms of increased poverty and progress towards the MDGs resulting from the crisis. It is reassuring that the G20 communiqué of April 2009 acknowledged that the global financial system is ill equipped for responding to the current crisis and agreed to deliver a large policy package. Another positive step is the recognition that developing countries that are hit by external shocks need to be provided with ample liquidity with no strings attached.

42. There are, however, also sources of concern. In particular, some of the resources necessary to fund the proposed $1.1 trillion package agreed upon in the G20 communiqué have yet to be identified. Moreover, it is not yet clear what terms and conditions will be attached to the new resources and whether the IMF which will receive more than 70 per cent of the new resources, will truly reform its conditionality policies. Nor did the G20 allocate enough resources to low-income countries and small and vulnerable states.

43. Low-income countries have limited ability to respond to external shocks and many of them are facing difficulties in servicing their external debt. It is the obligation of the international community to provide assistance and resources to help mitigate the adverse consequences of the crisis without allowing the accumulation of unsustainable levels of debt. Low-income countries with high debt levels need to be given alternative financing opportunities for MDG achievement. A debt moratorium or standstill would immediately and unconditionally liberate resources and give countries the fiscal space to respond to the specific circumstances they are facing. Such a moratorium can be viewed as a part of a multifaceted approach to mitigating the impact of the crisis and can reduce the build-up of unsustainable debt in vulnerable economies.

IV. Foreign direct investment for productive capacity-building

44. It is generally believed that FDI can make its contribution to domestic capacity-building and economic development through the transfer of capital, technology, skills, expertise and access to export markets. Based on this belief, a number of developing countries have adopted policies and strategies to attract FDI. However, the outcomes of such policies have been mixed. Countries' experiences have shown that the absence of a minimum level of domestic capacities will limit FDI inflows and their impact on development.

45. Governments of developing countries, especially least developed countries (LDCs), frequently face the following problem: they need to attract FDI to help build domestic capabilities and stimulate economic development, but economic development itself is a major determinant for FDI. Even if FDI has been lured by exceptionally attractive characteristics (such as natural resources), but the country does not enjoy other competitive advantages, FDI tends to operate as an enclave, with few linkages with the local economy. Thus, countries need to create and strengthen national capabilities, which serves the general purpose of development and goes beyond attracting FDI alone. Once economies gain development momentum, FDI, if needed, can be more easily attracted and can eventually contribute to improved domestic productive capacities, provided the right policies are in place. When such momentum has not yet been reached, FDI is not a viable policy tool to boost development.

46. The strengthening of domestic productive capacity is then paramount to effective FDI attraction. Experiences have shown, however that simply attracting FDI does not guarantee its contribution to domestic capacity building. This is the challenge faced by a number of developing countries. Developmental effects derive from the externalities generated by FDI via spillover channels and are thus strongly dependent on the conditions under which FDI interacts with the local economy.

47. The effect of foreign entry may be stimulating or restricting for domestic companies. The entry of transnational corporations (TNCs) can stimulate competition or rather contribute to highly concentrated or oligopolistic markets. If there is an increase in competitive pressure, some domestic firms are at risk of being crowded out, but others can be incentivized to improve their efficiency to a level that allows them to work or compete with TNCs. Spillovers allow local firms to improve their performance due to more stringent requirements or through direct assistance and knowledge transfer from their multinational customers. However, in many developing countries, TNCs are reluctant to source locally and rather encourage foreign suppliers to establish local facilities or source with independent suppliers abroad or decide to source in house.

48. One determinant for the likelihood of net positive spillovers between TNCs and the host economy is the absorptive capacity of local firms, which is related to the size of the performance gap between foreign-owned and domestic-owned firms, in areas such as productivity, profitability, wages, skills, labour relations and technology. If gaps are very large, absorptive capacity will be weak. In such a case, not only spillovers would be insignificant or unlikely to occur, but also there is a danger of growing duality in the economy as a result of the increasing gap in performance between the foreign sector and the rest of the economy.

49. To create and enhance synergies between foreign and domestic investment, developing-country governments need to strengthen domestic enterprises on the one hand and foster their interactions with foreign affiliates on the other hand. An integrated approach for development policy is vital for strengthening national productive capacity, covering education, competition, fiscal, monetary, trade and investment. The design of

policy for industry and enterprise – in particular small and medium-sized enterprises (SMEs) – in the light of the new rules governing international trade and of the rise of global value chains is of paramount importance.

50. In addition, a number of specific policy measures are helpful for creating synergies between foreign and domestic investment. These include:

(a) *Providing information and matchmaking*: Relevant government agencies can gather and disseminate information on investment and linkage opportunities and provide matchmaking services with regard to joint investment projects and buyer-supplier linkages;

(b) *Financing*: Various government options are available to encourage the provision of financial support by foreign affiliates to their domestic partners. For instance, governments can offer tax credits or reductions and other fiscal benefits to foreign affiliates providing short- and long-term funds to domestic suppliers. They can also co-finance supplier development programmes along with the private sector;

(c) *Technological upgrading*: Governments can adopt various policy measures such as imposing performance requirements and providing incentives, to encourage technology transfer from foreign investors to domestic companies and to promote technological cooperation between the two;

(d) *Training*: Governments can directly provide training programmes to domestic SMEs. They can also strengthen skills-development interactions between foreign affiliates and their local partners. Special attention should be given to buyer–supplier linkages;

(e) *Performance requirements*: Countries have to balance the potential benefits of performance requirements (such as local content, joint ventures and technology transfer) against the costs of creating inefficiency, the risks of deterring FDI and their international obligations. Particularly, countries with relatively strong bargaining positions – based, for example, on the size of the markets or the natural resources they give TNCs access to – can use performance requirements as a policy tool to enhance the benefits of inward FDI;

(f) *Incentives to create linkages*: Governments can offer incentives, such as tax exemptions, to foreign affiliates to encourage the creation of linkages (provided they are compatible with their international obligations). However, they should avoid granting incentives in situations in which linkages would be forged even in the absence of incentives;

(g) *Legal support for domestic suppliers to TNCs*: Governments can help balancing the negotiating position of buyers and suppliers through, for example, guidelines and model contracts;

(h) *Policy objectives and measures*: It is vital to have these clearly-defined along with well-functioning government agencies. The more the relevant policy initiatives are embedded in strategies that facilitate enterprise development in general, the higher is the likelihood that they will succeed.

V. Building productive capacities in least developed countries

51. It is increasingly recognised that productive capacities should be at the heart of national and international policies to promote sustained growth and poverty reduction in LDCs. That requires a policy shift from a narrow focus on Millennium Development Goals to a broader focus on promoting economic growth as well as achieving the goals. Growth policies in turn should not simply be concerned with allocative efficiency, but should also seek to harness natural and human resources, accelerate capital accumulation and build technological capabilities.

52. Governments of LDCs need a strategy that is nationally owned, tailored to local needs and adapted to changing national and international circumstances. With the recent global financial and economic crisis, the world economy is at a turning point and this poses major new challenges to the LDCs. The resulting economic deceleration has already reduced international trade growth and private financial flows to LDCs, and this will sharpen international competition for export markets and attracting FDI.

53. Building productive capacities requires scaling up investment; Governments need to establish incentives for capital formation for both public and private investment and to promote a financial system which effectively mobilizes and appropriately channels funds. Governments should also seek to attract FDI and harness it to develop domestic enterprises, while ODA should complement private investment.

54. Measures are also required to increase the productivity of capital and labour, particularly through technological learning and innovation. Building technological capabilities enables producers to export by meeting stringent quality standards and certification requirements increasingly demanded by international markets. LDCs should seek technology-driven increases in productivity through leveraging linkages with the global economy. Technological learning could be accelerated through national policies for science, technology and innovation.

55. In order to develop their productive capacities, LDCs have to tackle a range of supply-side constraints, especially:

(a) Physical infrastructure, especially energy, transport and communications. Energy supply is critical and, together with transport and communications, it makes possible internal and external connectivity of economic agents;

(b) Poor social service infrastructure, which implies insufficient supply of human resources, skills and managerial capabilities;

(c) Weak financial systems;

(d) Insufficient investment in research and development, technological learning and innovation systems; and

(e) Better integration of environmental sustainability into the development of productive capacities and measures to adapt to climate change.

56. The sectoral orientation of LDCs' strategies for developing productive capacities should encompass agriculture, industry and services as follows:

(a) Agriculture needs to receive new domestic and international policy attention, especially increased investment and technological upgrading. The new generation of agricultural policies should not focus solely on agricultural production, but rather will have to be developed in the context of agribusiness and value chain development. A balance should be struck between staples and cash crops, which strengthened food security while also allowing for the growth of exports;

(b) Industrial development is a response to the LDCs' need for diversification of production, employment and exports. Industry development requires a new type of industrial policy based on dialogue and consensus between the public and private sectors;

(c) Efficient commercial services are necessary to the development of both agribusiness and industry, including not only transport and logistics, but also finance, consulting and other knowledge-intensive services.

57. Although agricultural development is vital in most LDCs, and its neglect has been highlighted by the current global food crisis, population and poverty in LDCs are becoming increasingly urban in the first half of the twenty-first century. The expansion of the

secondary and tertiary sectors is necessary, as they generate jobs to absorb surplus workers leaving agriculture and thereby reduce poverty. Structural transformation must favour more knowledge-intensive goods and services in all sectors of economic activity.

58. Entrepreneurship is the basis for building productive capacities and the private sector has a crucial role to play. While microenterprises contributes to managing poverty, building entrepreneurship requires developing small and medium-sized enterprises (the "missing middle"). Preconditions for the development of the private sector are peace, stability, rule of law, predictability, transparency, equity in taxation and democratic practices. New forms of public–private partnerships must be developed. Women make a major contribution to productive capacities development. They run a substantial share of microenterprises in LDCs and women entrepreneurship is a major force in private sector development.

59. In the above areas, ODA can help to build up the knowledge resources and knowledge systems of LDCs. This is particularly important for the LDCs because knowledge accumulation and technological learning through international market linkages are currently weak in the LDCs. In that situation, there is a real danger of socio-economic marginalization for the now-open LDC economies as knowledge becomes increasingly important in global competition.

60. As noted earlier, there is still insufficient discussion of the impact of the composition of aid on its effectiveness. Thinking about knowledge aid is particularly important for ensuring aid effectiveness. Knowledge aid is defined as aid which supports knowledge accumulation in partner countries through the development of their knowledge resources and their domestic knowledge systems. On the part of donors, enhancement of knowledge aid can be done through internal reforms to increase intra-organizational knowledge-sharing, better knowledge management and IT system development. The concept can also be taken further by providing partner countries with access to that donor knowledge.

61. Partner-centred approaches are designed to support directly knowledge accumulation in partner countries. Aid for science, technology and innovation (STI) is a particular form of knowledge aid which is focused on STI capacity of partner countries. There needs to be a more systemic and strategic approach to supporting the development of STI capabilities in the LDCs. This should go beyond ad hoc projects to strengthen parts of public STI infrastructure, particularly universities, and support innovation at the enterprise level by supporting the development of capabilities and knowledge systems. It should support firms as well as farms. In this respect, UNCTAD's Science Technology and Innovation (STIP) review programme is a useful tool for assessing countries' capabilities for designing appropriate policies to promote technological learning and innovation.

VI. Issues for discussion

62. Against this background, experts may wish to elaborate on the following questions:

(a) In what circumstances are external financial resources required for productive capacity-building?

(b) What are the reasons behind the fast accumulation of foreign exchange reserves in many developing countries?

(c) What has been the impact of foreign exchange accumulation on productive capacity building and growth?

(d) What are the macroeconomic policies necessary to mobilize external financial resources for building productive capacities?

(e) What are the main challenges for increasing the effectiveness of foreign aid? What are the responsibilities of donor countries in this regard? What about recipient countries?

(f) Are donors suffering from aid fatigue? If so, what should be done to combat this problem and increase the overall aid envelope in a period of recession in many donor countries?

(g) What are the pros and cons of aid targeted to specific projects vis-à-vis general budget support? Are some types of aid more appropriate for certain countries?

(h) What can be done to improve the predictability and stability of aid flows?

(i) How has the current crisis affected debt sustainability in emerging market countries and low-income countries?

(j) How does corporate debt affect the sustainability of public debt? How can the risk associated with excessive external borrowing by the corporate sector be reduced?

(k) How can developing countries modify their debt structure in order to become more resilient to external shocks? Are domestic policies sufficient or is an international effort necessary for creating new and safer debt instruments?

(l) What are the main strengths and weaknesses of DSF for low-income countries? Are the debt thresholds identified in the DSF in the right ballpark? Is the CPIA the best measure to evaluate the quality of a country’s institutions and policies?

(m) How does FDI affect the productivity of domestic firms and what is the role of FDI policies in overall development strategies?

(n) What policies are needed to encourage linkages between foreign and domestic enterprises?

(o) What strategies may developing countries pursue for enhancing policy space both to pursue development objectives and to reap greater benefits from FDI in light of their international obligations?

(p) What is the role of the State in developing productive capacities?

(q) What are the resource requirements for developing economic infrastructure in LDCs and how can they be met?

(r) How can ODA be used to leverage development finance and knowledge aid?

(s) How may the composition of aid be shifted towards productive sectors and economic infrastructure without compromising progress on MDGs?