

## **DEVELOPMENT COOPERATION WITH MIDDLE-INCOME COUNTRIES**

### **Executive Summary**

1. In the last several years the international community has taken important steps to formulate in a more precise and concerted way its commitment to the fight against poverty. Through the Millennium Declaration and the adoption of the Millennium Development Goals, it has been possible to put together a program of basic development targets to which the whole international community is now committed. This achievement has been accompanied by a series of reforms in the development cooperation system aimed at facilitating a better absorption of development assistance on the part of the recipients, better coordination and harmonization of policies on the part of donors, and an effective alignment of those policies with the national development strategies of the recipient countries. The Monterrey Consensus and the Paris Declaration on Aid Effectiveness are both important landmarks in this process.
  
2. These developments have also been accompanied by a strong emphasis on directing foreign assistance toward the lower-income developing countries, where the levels of poverty are generally more acute. But this approach -though appropriate- could give rise to insufficient support to the development and poverty eradication efforts of middle-income countries (MICs). There exist many important reasons and objectives why the international community should maintain its support, appropriately defined, to this important group of countries. Among them are:
  - To contribute to the efforts toward the eradication of poverty. Forty-one per cent of the world's people living on less than two dollars a day live in MICs. Even though the principal responsibility for the fight against poverty rests with the respective national governments, international cooperation can be a key to overcome vicious circles and accelerate progress in this regard.
  - To forestall losing ground in the social and economic progress already achieved. The high volatility of economic growth in a considerable number of MICs has resulted in many instances of regression in the fruits of development. Thus, a central objective of the system of international cooperation should be to consolidate and make irreversible achievements in terms of development.
  - To help MICs serve as poles of development at the regional level. The economic size of some of these countries is such that their dynamism becomes an important driving force for the respective regions or subregions. It thus makes sense that the international community should take advantage of these externalities to help maximize the positive effects of its aid programmes in each recipient region.
  - To support MICs' contributions in the provision of international public goods, such as peacebuilding, prevention of contagious diseases, financial stability, and environmental sustainability.
  - To consolidate a system of international cooperation that provides consistent incentives and rewards, avoiding a negative segregation of recipients that would discriminate against those who have made the largest advances.

3. Just as an abrupt divide between recipient countries should not exist, it should also not be there among those who contribute to the development cooperation system. This means that, just as developed countries may be asked to cooperate with the developing efforts of MICs, this last group should also play an increasingly larger role in South-South cooperation, both among themselves and with lower-income developing countries. And this type of cooperation can be promoted and supported by developed countries through “triangular cooperation” modalities.
4. MICs are very heterogeneous in terms of size, development potential and economic and social achievements. This makes it difficult to formulate a single approach to address their needs and makes it necessary that the international community tailor cooperation programmes to the particular circumstances of each country and group.

#### *Scope and Strategies for Action*

5. Even though in the past many MICs have undergone phases of accelerated growth, it has often not led them to stable paths of sustainable growth and this is an important obstacle to their development. Though the problems vary widely, these seem to be related to institutional weaknesses and lack of social cohesion in the MICs, vulnerabilities associated with their integration into international financial markets, and difficulties faced in generating a sustained, dynamic process of technological and productive development.
6. Development assistance has a limited role in the finances of MICs. For this reason, the effectiveness of aid to these countries will depend on its capacity to mobilize additional resources or to attract other sources of international financing. A good part of the foreign assistance to MICs is focused on advisory services and technical assistance, support to the design of economic policies, establishment and strengthening of institutions and the sharing of experiences. In the pursuit of these objectives, national capacities and experiences should be used as much as possible. And just as important as aid are the other components of international cooperation; it is therefore crucial to improve the levels of coherence among donors’ policies.
7. Among these latter elements, the multilateral framework which MICs utilize in order to participate in the international economic system plays a fundamental role. The nature and scope of regulatory frameworks in the trade, finance and technological fields play a crucial role in defining their space to undertake national action as well as in exploiting opportunities in international markets. It is therefore necessary to provide MICs an enhanced voice and representation in global economic institutions which correspond more closely to their economic size and populations.
8. Multilateral Development Banks (MDBs) also play an essential role for MICs, especially for those that do not have stable access to private capital markets. These institutions operate through the granting of loans, new financial instruments –such as guarantees-, technical assistance and support for capacity-building efforts. The following have great potential in meeting the needs of MICs: development of instruments to mitigate the risk

of external disturbances; financing of local public institutions; financing of new private activities, such as infrastructure; and development financing in domestic currencies. In the same vein, it is necessary that MDBs strive to correct the excessively demanding and complex nature of conditionality, transaction costs which are too high, and their insufficient attention to the characteristics, procedures and specific needs of MICs.

9. Due to its horizontal structure, South-South cooperation has a great potential to generate a sense of ownership on the part of recipients, promote initiatives more relevant to the needs and conditions of the respective countries and further activities which generate a “double dividend”, such as the utilization of technical and institutional capacities of both donors and recipients. South-South cooperation has been manifested in the following three important areas: (i) macroeconomic cooperation, especially through dialogue on economic policies and provision of liquidity in times of crises; (ii) financing for development – through MDBs owned by developing countries and initiatives for the creation of regional bond markets; and (iii) technical cooperation.

#### *Social Cohesion, Democratic Governance and Institutional Development*

10. Development processes often generate distributive tensions which need to be channeled through effective and legitimate institutions. It is a two-way relationship: effective institutions are required to promote social harmony, striving to bring income and wealth distribution within the levels considered socially desirable; but, at the same time, the correction of social inequalities fosters the consolidation of the institutional system, increasing its degree of legitimacy.
11. Notwithstanding the diversity of situations and limited knowledge about processes of institutional change, there are several generally agreed principles. Thus, it is recognized that institutional frameworks are highly specific to each context and that there is no universally-optimal institutional design. It is also recognized that it would not be necessary to carry out far-reaching reforms in order to begin an effective process of institutional improvement: it suffices to produce credible –and thus sustainable–enhancements which can change in a positive way the behavior of the various players. Changes will be sustainable to the degree that they generate a reduced number of “losers” and widen with time the number of “beneficiaries”. These principles imply that gradual reforms can help make feasible effective progress in institutional change. In this regard, the building of high-quality public administrations and the fight against corruption play a crucial role in the process of institutional development.
12. Even though the task of institutional change is the responsibility of MICs themselves, international cooperation can provide support to this process through two fundamental channels: the dissemination and exchange of experiences that can be replicated –thus reducing innovation costs– and encouraging arrangements conducive to the empowerment of social groups who cooperate with institutional change and exert pressure to make those institutions more inclusive and accountable.

13. A large number of MICs have had difficulties in making their growth processes compatible with substantial reductions in levels of poverty. However, it is possible to achieve compatibility between growth and equity objectives. Experience shows that redistributive policies do not necessarily reduce market efficiency. Redistributive spending, especially in the education and health sectors, can indeed reduce poverty without hindering the rate of economic growth. One valuable recent experience is the development of transfers to poor families which are made conditional on school attendance and the use of basic health services. Similarly, the history of MICs demonstrates that severe macroeconomic shocks can increase their poverty levels substantially, which highlights the importance of setting up social safety nets in anticipation of possible crises.
14. The need to implement redistributive policies leads MICs to increase social spending, which calls for a broadening of the respective governments' fiscal capacities. International cooperation in these areas can help both from the financial and the technical assistance aspects, to enlarge the provision of social services and contribute to the consolidation of social protection networks.
15. Tax management is also a central aspect in development processes: it affects the economic behavior of individuals and enterprises, defines the capacity of action of the public sector, and provides a framework for the social covenant on which the concept of good citizenship is built. Nonetheless, putting together a fiscal system that combines the characteristics of sufficiency, efficiency, equity, administrative simplicity and flexibility is a great challenge. Notwithstanding the heterogeneity of MICs, there is still room to reform tax systems to enhance, broaden and make them less regressive. International cooperation can be of help in this process, assisting in the design and technical development of tax reforms, in the improvement of statistics, in human resource training and in the strengthening of tax management institutions. Along the same lines, globalization, mobility of capital, and tax competition among countries call for greater international cooperation in areas such as double taxation, tax evasion and fraud.

*Financial Stability and Innovation.*

16. While the liberalization and deregulation of capital markets and financial innovation have increased the efficiency of international capital markets, they have also increased the risks of instability accompanying rapid capital movements and of widespread contagion of financial crises. The MICs have experienced both sides of this process. Reducing such risks requires a consolidation of macroeconomic fundamentals, creating more space for counter-cyclical policies and strengthening prudential regulation and financial supervision. At present, financial markets are less tight than a decade ago (and MICs and other developing countries are taking precautionary measures in this regard, like increasing their international reserves), yet there is no guarantee that critical situations will not recur. Because of this, domestic responses must be supplemented with international action.

17. A critical problem lies in the different capabilities and lack of continuity in the access to international markets by developing countries. This has a significant impact on the degree of autonomy of economic policies. In the case of MICs, the mix of volatile capital markets and high debt levels compounds the cyclical behavior of their economies. During boom periods, capital markets encourage expansionary policies; during recessions, governments have to emphasize restrictive measures, impacting negatively on investment and growth. Herein lies the importance of adopting counter-cyclical macroeconomic policies.
18. A crucial element for that objective is a degree of flexibility in managing the exchange rate, having in mind that there is no optimal approach for all countries. Another crucial element is fiscal policy. Despite the problem mentioned above, it is possible to achieve a degree of autonomy vis-à-vis the cycle through the establishment of medium-term fiscal targets -adjusted according to the economic cycle- and stabilization funds. At the same time, measures directed at some regulation of the capital account can assist the design of counter-cyclical policies and improve the country's external debt profile.
19. The development of domestic financial markets - particularly deep bond markets, both public and private – is indispensable for MICs to achieve greater autonomy in economic policy formulation and to improve access to international capital markets. The efficiency and competitiveness of banks are also essential, as well as the establishment of a sound normative framework and information, regulation and supervisory structures.
20. Access to banking services for all is considered a central element in a country's economic and social development. Together with the government, banking institutions have a major responsibility in expanding services to all, by democratizing services and adapting products and decentralized operations to the needs of lower income groups and individuals. In this connection, the development of microfinance institutions – which can also be supported by international cooperation - can make a significant contribution.
21. MICs have a lot to gain from forward-looking reforms in the international financial system. Two basic objectives should guide such reforms: to promote an adequate supply of capital, both official and private, to the different categories of developing countries, and to reduce the instability of financial flows – trying to prevent crises and avoid contagion. To achieve this, it will be necessary, *inter alia*: to adopt sound regulatory mechanisms and prudential regulation of financial systems; to set up institutions able to inject resources to those economies that experience an acute liquidity crisis (this suggests the need to provide operational capability to the IMF as a lender of last resort and guarantor of the stability of the international financial system); to design effective instruments to support efforts to reduce or restructure external debt, including sovereign debt; to strengthen international financial institutions so they can confront new problems, such as the regulation of new financial instruments (derivatives) and the large global imbalances; and to enhance the representation and participation of developing countries in those institutions.

*Trade Integration and Competitive Advantages.*

22. Well designed international trade policies improve productive efficiency, facilitate technology enhancements, promote competition, make it possible to benefit from economies of scale and contribute to the alleviation of external restrictions to growth. Nonetheless, development is not an automatic consequence of opening the economy. Without adequate complementary policies, the opening of the economy will have limited impacts and even negative ones in the short run. In the last two decades, MICs have made marked efforts to open their economies, increasing exports and imports. Despite this, their production and export structures remain quite different from those of developed countries; the former have a large component of primary commodities in their exports and, therefore, experience more instability in their export revenues. Besides, they experience a significant concentration of export markets and export products.
23. More than eighty per cent of MICs are members of WTO and almost all the rest have observer status. Even though abiding by trade agreements is indispensable, it appears reasonable that in trade negotiations the MICs request that the universality of the trade norms be compatible with some room for maneuver to formulate domestic policies necessary to promote development. For many MICs, agricultural trade negotiations are critical. The high level of protection accorded to agricultural markets in developed countries – where high tariffs accompany production and export subsidies – is incompatible with trade openness and constitutes a formidable obstacle to the exports of many developing countries, including the MICs.
24. Besides progress in those areas, international cooperation could assist those MICs that lack the technical capacity to participate in international negotiations and need resources and technical assistance to increase their export supply and the international integration of their enterprises.
25. In the field of the development of technological capacities, international cooperation can be decisive. The international transfer of knowledge can lead to rapid technological progress in diverse areas. Scientific cooperation through training programmes, exchange of researchers and cooperation networks between teams and research centres can be particularly beneficial to MICs. As much as in domestic and international efforts, a strategic association between universities and enterprises could play a key role. At the same time, it is important to consider ways in which foreign direct investment can contribute in the long-run to technological progress in the host country.
26. Another crucial factor in international competitiveness is the stock and quality of the physical infrastructure. Investment in infrastructure expands aggregate demand, and generates employment and growth in the short run. In the long run, it increases productive efficiency, facilitates market integration and enhances the provision of basic services to the population. In a large number of MICs, the difficulties from financial crises of the last 25 years have led to a substantial deficit in this area. Reviving infrastructure investments is, thus, a central factor to accelerate development. A pragmatic approach of public/private partnerships can contribute to this effort.

27. From a financial stand-point, reviving infrastructure investments will require efforts that go beyond fiscal budget possibilities and eventual domestic or international private financing. Official resources –bilateral and (particularly) multilateral- can, therefore, be decisive in this area. This constitutes one of the priority challenges of international cooperation with MICs.

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