Economic & Social Affairs

# Overcoming economic vulnerability and creating employment

Report of the Committee for Development Policy on the eighth session (20-24 March 2006)

United Nations

Department of Economic and Social Affairs

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United Nations
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## DESA

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# Foreword

Over the years, the Committee for Development Policy (CDP) has provided valuable independent advice to the Economic and Social Council and contributed to a better understanding of emerging development issues. Given its multidisciplinary and independent nature, the CDP has the potential to be an influential instrument for serving Member States: it can serve as a forum to deliberate key economic and social issues to further the United Nations development agenda and to signal new issues for consideration by the Council.

An example of the Committee's merit is its accumulated expertise on the status of the least developed countries and other vulnerable groups. The Committee's clear mandate to identify least developed countries and to conduct a triennial review of the list has allowed it to work effectively in this area. This year, the Committee recommended that one new country (Papua New Guinea) be added to the list and that one (Samoa) be graduated. It should be of great concern to the international community that, despite the strong economic performance of some of the poorer countries in recent years (see *World Economic Situation and Prospects 2006*[a]), there appears to be a need to add new countries to the list, while only a few countries are in a position to be recommended for graduation.

In 2006, in addition to this triennial review, the Committee addressed two themes central to the United Nations development agenda. The first dealt with the nature and causes of the unemployment problems that confront many developing countries, including those countries where recent robust economic growth has failed to generate new and better jobs. This theme has also been addressed this year by the United Nations at a broader

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level by assessing strategies towards achieving the goal of full and productive employment and decent work for all. The related analyses and discussions in the CDP have led to a number of important recommendations.

At the international level, development partners need to work towards ensuring that employment objectives are fully and explicitly integrated into growth-enhancing and poverty-reducing policies and strategies. Particularly important is the recommendation that the international community should pursue a more balanced and coordinated international strategy for sustainable global growth and full employment, based in part on an equitable sharing of responsibility for maintaining high levels of effective demand in the global economy. Greater integration into the world economy may generate new employment opportunities, but it may also lead to job losses and increased vulnerability.

The commitment by Governments to reduce poverty requires continued efforts to reconcile the objectives of economic growth and employment generation within a coherent macroeconomic framework. At the national level, employment generation has to become a key priority—not only of social development strategies but also, and perhaps mainly, of economic strategies and policies at both the macroeconomic level and the level of production sectors. The rate of economic growth is important, but even more crucial is the quality of such growth, measured in terms of its capacity to generate jobs. I welcome, in particular, the Committee's emphasis on creating the necessary fiscal space in developing countries to make the requisite investments in education and training so as to ensure the availability of an adequately skilled workforce to meet the technological challenges posed by increasing openness to global markets.

The second theme addressed by the Committee at its eighth session concerned coping with economic vulnerability and instability. The Committee discussed the challenges in designing and implementing policy measures to prevent economic shocks and to mitigate their effects when they do occur. At the national level, appropriate policies for promoting good governance, effective public programmes and sound fiscal and financial management can contribute to lowering the economic risks posed by vulnerability and, as a result, have important effects on economic growth and the process of economic convergence. Domestic policy efforts, however, are often weakened by external shocks. The international community therefore has an important role to play in countries' efforts to cope with economic instability. The Committee assessed international efforts to mitigate economic vulnerability, focusing on how such efforts may have reduced the likelihood of systemic shocks and whether they have enhanced the resilience of individual countries to shocks.

I hope that the analyses and recommendations contained in the present report will enrich the international development dialogue on employment and economic vulnerability, and pave the way for viable and effective solutions and policies. I also believe that, in the follow-up to the 2005 World Summit and the ensuing reform process of the Council, the Committee can make a significant contribution to the new mandates entrusted to a Council powerfully geared towards advancing implementation of the United Nations development agenda.

José Antonio Ocampo
Under-Secretary-General
for Economic and Social Affairs

# Preface

The Committee for Development Planning was established in 1965 as a subsidiary body of the Economic and Social Council. Its original terms of reference were subsequently modified and, in 1998, the Committee was renamed the Committee for Development Policy (CDP).

The Committee provides inputs and independent advice to the Council on emerging cross-sectoral development issues and on international cooperation for development, focusing on medium- and long-term aspects. The Council is an intergovernmental body responsible for formulating policy recommendations to Member States and to the United Nations system on matters pertaining to development. It is also responsible for coordinating the work of the United Nations specialized agencies, its own subsidiary functional commissions and the five United Nations regional commissions.

Each year, the Council advises the Committee about the theme(s) that the Committee should consider at its annual session. The General Assembly, the Secretary-General and the subsidiary bodies of the Council can also propose, through the Council, issues for consideration by the Committee. In addition, the Committee itself often makes suggestions to the Council concerning its work programme.

The Committee is also responsible for undertaking, once every three years, a review of the list of least developed countries, on the basis of which it advises the Council regarding countries which should be added to, and countries that could be graduated from, the list. In its identification of least developed countries, the Committee considers three dimensions of a country's state of development: (a) its income level, measured by gross national income (GNI) per capita; (b) its stock of human assets, measured by a Human Assets Index (HAI); and (c) its economic vulnerability, measured by an economic vulnerability index (EVI).

The annual meeting of the Committee usually takes place in March or April of each year and lasts five working days. During this period, the Committee discusses the agreed topics and drafts its own report on the basis of inputs from members. The report is subsequently submitted to the Council at its substantive session in July and is also disseminated among the development community.

The reports of the Committee are available on the Internet at www.un.org/esa/policy/devplan/.

## Membership of the Committee

In accordance with the resolutions of the Council, the Secretary-General nominates 24 experts, in their personal capacity, as members of the Committee for three-year terms. The Council has responsibility for deciding on appointments to the Committee. In making the nominations for the Committee, the Secretary-General takes into account the need to have a diversity of development experience, including ecologists, economists and social scientists, as well as geographical balance, gender balance, and a balance between continuity and change in the membership of the Committee. The members appointed for the term starting on 1 January 2004 and expiring on 31 December 2006 are as follows:

- Ms. N'Dri Thérèse **Assié-Lumumba** (Côte d'Ivoire) Research Associate, Université de Cocody;
- Ms. Iskra **Beleva** (Bulgaria) Senior Research Fellow, Institute of Economics, Bulgarian Academy of Sciences;
- Ms. Patricia **Bifani-Richard** (Chile-Italy) Psychologist, Sociologist;
- Mr. Albert **Binger** (Jamaica) Professor and Director of the Centre for Environment and Development, University of the West Indies;

- Mr. Olav **Bjerkholt** (Norway) Professor of Economics, University of Oslo;
- Ms. Gui Ying **Cao** (China) Research Scholar, International Institute for Applied Systems Analysis;
- Mr. Eugenio B. **Figueroa** (Chile) Executive Director of the National Centre for the Environment;
- Mr. Leonid M. **Grigoriev** (Russian Federation) Deputy Director, Expert Institute;
- Mr. Patrick **Guillaumont** (France) Chairman, Centre for Study and Research for International Development;
- Ms. Heba **Handoussa** (Egypt) Adviser, Economic Research Forum for Arab Countries, Islamic Republic of Iran and Turkey;
- Mr. Hiroya **Ichikawa** (Japan) Professor of Economics, Department of Comparative Culture, Sophia University;
- Ms. Willene **Johnson** (United States of America) Adviser, Board of Governors, Federal Reserve System;
- Ms. Marju **Lauristin** (Estonia) Professor of Social Communication, Department of Journalism and Communication, Tartu University;
- Mr. P. Jayendra **Nayak** (India) Chairman and Managing Director of Unit Trust of India Bank, Mumbai;
- Mr. Milivoje **Panić** (United Kingdom of Great Britain and Northern Ireland) Fellow of Selwyn College, University of Cambridge;
- Ms. Carola **Pessino** (Argentina) Professor, Universidad Torcuato di Tella, and Executive Director of the Centre for Social Economics Evaluation and Research for Poverty Alleviation;

- Ms. Suchitra **Punyaratabandhu** (Thailand) Dean, School of Public Administration, National Institute of Public Administration, Bangkok;
- Ms. Sylvia **Saborio** (Costa Rica) Development Consultant and Adjunct Professor, Georgetown University, Washington, D.C.;
- Mr. Nasser Hassan **Saidi** (Lebanon) First Vice-Governor of Banque du Liban;
- Mr. Udo Ernst **Simonis** (Germany) Professor of Environmental Policy, Berlin Science Centre;
- Ms. Funmi **Togonu-Bickersteth** (Nigeria) Director, Centre for Industrial Research and Development, Obafemi Awolowo University;
- Mr. Geedreck **Usvatte-Aratchi** (Sri Lanka) Consultant in economics and public finance, Central Bank of Sri Lanka;
- Mr. Samuel **Wangwe** (United Republic of Tanzania) Principal Research Associate, Economic and Social Research Foundation;
- Mr. Kerfalla **Yansane** (Guinea) Lead consultant, African Peer Review Mechanism, Secretariat of the New Partnership for Africa's Development.

The Committee elected the following officers for its eighth session:

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| *Chairperson:* | Ms. Suchitra Punyaratabandhu (Thailand) |
| *Vice-Chairperson:* | Mr. Milivoje Panić (United Kingdom of Great Britain and Northern Ireland) |
| *Rapporteur:* | Ms. Sylvia Saborio (Costa Rica) |

## Contents of this publication

At its eighth session, held at United Nations Headquarters in New York from 20-24 March 2006, the Committee addressed three topics: (i) creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development; (ii) coping with economic vulnerability and instability: national and international policy responses; and (iii) the review of the status of least developed countries. The report of the Committee on its eighth session has been issued as part of the official records of the Economic and Social Council, 2006, (Supplement No. 13 (E/2006/33)) and is also available on the Internet at www.un.org/esa/policy/devplan/. The views of the Committee on the three topics are contained in its report and reproduced in this volume.

In addition to the topics addressed in the report of the Committee on its eighth session, this volume contains a paper on policy responses to economic vulnerability which, along with other background material, provided a basis for discussions at the session.

It is hoped that these materials relating to the work of the Committee will contribute to discussions on these matters at all levels, leading to practical solutions, policies and actions by all concerned.

# Executive Summary

The present report contains the main findings and recommendations of the eighth session of the Committee for Development Policy, held at United Nations Headquarters from 20 to 24 March 2006. The Committee addressed three themes: the first concerned creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development; the second concerned coping with economic vulnerability and instability; and the third concerned the triennial review of the identification of the least developed countries.

With regard to the first theme, the Committee is of the view that creating an environment for full and productive employment and decent work for all should be a key objective of domestic economic and social policy, since productive employment is central to fighting poverty and providing adequate social security. However, this goal remains unattainable in many developing countries where a large share of workers are trapped in low-skill/low-wage jobs in the agricultural and informal sectors. Thus, higher levels of investment in human capital are needed to improve the employability of workers and increase the benefits from economic growth. Countercyclical policies are needed to protect jobs and incomes and provide adequate social security in times of economic shocks and natural disasters. The Committee stresses that the international community should make the objective of reaching full productive employment and decent work an integral part of trade, financial arrangements and development assistance to developing countries, particularly the least developed countries.

Regarding the second theme, the Committee observes that countries that have been successful in preventing or managing shocks have done so by adopting a long-term strategy shaped by the constructive use of local knowledge. Countries such as Botswana, Cape Verde and Mauritius increased national capacity in a few key areas of governance, human and social development, and fiscal and financial management. The Committee recommends that the international community assist developing countries, particularly the least developed countries, in their efforts to strengthen capacity in several key areas, such as developing infrastructure and business activities. Developed countries should not undermine developing countries' development by limiting market access, or by delaying reform of their agricultural policies and maintaining agricultural subsidies. The international community needs to provide technical assistance to the least developed countries in responding to vulnerability caused by environmental stress or ecological damage.

As to the third theme, in its triennial review of the list of least developed countries, the Committee considers three dimensions of a country's state of development: its income level (gross national income per capita), its stock of human assets (the human assets index) and its economic vulnerability (the economic vulnerability index). To be added to the list, a country must satisfy the threshold levels for inclusion based on all three criteria. To become eligible for graduation, a country must reach the thresholds for graduation for at least two of the three criteria, or its gross national income per capita must exceed twice the threshold level. To be recommended for graduation, a country must be found eligible for graduation in two consecutive triennial reviews. The Committee recommends that Papua New Guinea be included in the list and that Samoa be graduated from the list. Furthermore, the Committee finds Equatorial Guinea, Kiribati, Tuvalu and Vanuatu eligible for graduation for the first time.

# Contents

# I. Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development

Full and productive employment is the surest means of fighting poverty and integrating weaker sections of society into the mainstream. For most people, employment is the sole source of income. Employment adds to the dignity of people because it is indicative of their value to society. In its resolution 60/1, the General Assembly adopted the 2005 World Summit Outcome, by which the Heads of State and Government attending the 2005 World Summit reaffirmed their commitment

> "to make the goals of full and productive employment and decent work for all, including for women and young people, a central objective of our relevant national and international policies as well as our national development strategies, including poverty reduction strategies, as part of our efforts to achieve the Millennium Development Goals".

In the pursuit of productive employment and decent work, both nations and the international community recommit themselves to the principles of sustainable development.

Opportunities for decent work depend critically on the productivity of employment and on government policies. In developing countries, the division of labour and organization of work do not yet permit the very high levels of productive employment characteristic of developed countries. As a result, a high proportion of labour in developing countries is in part-time, temporary or seasonal employment amounting, in effect, to underemployment.

## A. Challenges

Creating an environment conducive to generating full and productive employment and decent work for all requires, first and foremost, stable, predictable and sustainable long-term growth under conditions of peace and security. In addition, such growth should not make extreme demands on the resource base or place unsustainable burdens on ecological systems. Policies at both the national and international levels should foster the use of clean technologies and increasing resource productivity.

The Committee for Development Policy recognizes that employment conditions differ widely across developing countries. Hence, both the analysis of the issues and the policy responses should be country-specific. Nonetheless, it is possible to identify a number of issues and types of problems common to broad groups of countries, as addressed below.

In the formulation of national economic policy, the primary issue is the pattern of economic growth and technological choice. Given the persistent challenge of labour-abundance in developing countries, achieving full employment should be an overarching objective of the development strategies of those countries, both as an end in itself and as a critical means to poverty reduction. As such, the employment objective should be central both to macroeconomic as well as to trade and industrial development policies. The development experience over the last decade suggests that more attention should be paid to the balance between capital-intensive and labour-intensive options.

The Committee notes that achieving full and productive employment and decent work for all is not the outcome of any particular policy but of a host of measures and activities undertaken by myriad economic agents. While macroeconomic policies affect the overall level of employment, microeconomic policies influence the choice of economic activities as well as the intensity of labour use. The selection and effectiveness of national policies depend on initial conditions, as well as on the availability of particular policy instruments and effectiveness in the implementation of chosen policies. The Committee reviewed several policy challenges, keeping in mind that no one policy prescription fits all countries at all times.

Growth in productive employment has not kept pace even in countries experiencing strong economic growth in recent years. In other countries, especially in sub-Saharan Africa, the rate of economic growth has been far too low to generate much employment. Recurrent natural disasters, tenacious public health problems, including HIV/AIDS, internal and external conflicts, persistent declines in their terms of trade and policy failures have prevented many African countries from exploiting opportunities for economic growth and employment creation. Additional international support as well as an improved policy stance are essential to turn this situation around.

Open unemployment is one of the manifestations of the failure to provide productive employment. With public sector employment in developing countries on the decline for various reasons, the challenge is for the private sector—the main source of employment and growth—to expand at such a pace as to absorb those currently unemployed, as well as net additions to the labour force. Where Governments retrench and the formal private sector is unable to pick up the slack, the informal sector becomes the source of employment of last resort.

Another manifestation of the failure to provide productive employment is underemployment, characterized by masses of the working poor trapped in low-skill/low-wage jobs in agriculture and the informal sector. Fifty per cent of the working population in the world earned less than $2 per day in 2005, according to recent estimates of the International Labour Organization (ILO).[1] In the extreme case of Africa, formal wage employment accounts for only 10 per cent of the labour force and the bulk of jobs is in self-employment in agriculture and the informal economy. Elsewhere in the developing world, the share of informal sector employment is also on the rise.

Markets cannot always be relied on to provide full and productive employment and decent work or to minimize unfavourable impacts on the environment. Considerations of market efficiency and flexibility therefore need to be balanced with considerations of social protection. Striking a balance between flexibility and efficiency is critical in the policy dialogue for creating an environment conducive to employment generation and decent work. Productivity gains and labour-saving technologies, especially in developed economies, allow for output gains with little increase in labour input (i.e. jobless growth), while in developing countries the demand for labour is often held back by inadequate effective demand. Meanwhile, high population growth and other demographic factors add to the labour pool.

The Committee noted the importance of institutions—comprising laws, customs and practices—to the attainment of employment objectives in a society. Governments providing law and order, which are accountable to the governed and efficient in the conduct of business are fundamental to an environment conducive to the generation of productive employment and decent work. Laws relating to the enforcement of contracts and the functioning of other market institutions are the foundation for the growth of an efficient and thriving private sector. Regulations may influence the rates of profits to wages. For instance, regulations concerning minimum wages, severance pay and other employee benefits may

**1** *Global Employment Trends Brief* (Geneva, January 2006, International Labour Office).

tilt incentives in favour of existing employees. However, they may also stimulate job creation, or have an effect on job security or flexibility in hiring practices.

Macroeconomic policies should not lose sight of the urgent need for more and more productive employment and decent work. At the same time, policies promoting economic growth and employment should be tailored to avoid high inflation and build capacity to deal effectively with external shocks. The Committee noted the contrasting experiences in Latin America, where rapid growth was thwarted in the past by high rates of inflation, and in China and India, where high rates of growth have persisted without igniting inflation. These differences provide important lessons for the future.

Destabilizing shocks to economic systems can emerge suddenly from within or from without. Policy errors in domestic financial markets can be severely aggravated by capital flight and by the swift movement of capital made possible by technological innovations. Indeed, the further opening to international trade and foreign investment entails potential benefits as well as pitfalls. Freeing up the capital account in developing countries is something far more complex than was imagined in the early 1990s. Remedial measures in response to shocks in international financial markets recommended by the International Monetary Fund (IMF) in the 1990s have been modified in the light of experience and deserve to be examined further.

## B. Capital and technology create productive employment

Central to productive employment is the use of capital, both physical and human. The most notable difference between workers in developing and developed countries is in the amount of such capital per worker. In some cases, human development takes precedence; in others, the construction of infrastructure and the acquisition of equipment are deemed more important. A healthy and educated population is not possible without access to health and educational facilities; in turn, it cannot find productive employment without factories and equipment, roads and railways.

Increases in productivity are driven, in part, by technological progress, but in the case of developing countries, structural change and economic diversification are also important drivers. In an increasingly integrated global market, policies promoting such changes are essential for least developed countries and other countries to improve their competitiveness. An appropriate regulatory and institutional environment is required to raise both domestic and foreign investment for such purposes. Where inadequate purchasing power in the domestic market curtails the prospects for such investments, innovative national employment policies, such as the 2005 Rural Employment Guarantee Act in India, may be appropriate, especially for larger economies with well-integrated domestic economic structures.[2]

A vast majority of enterprises and workers in developing countries are not part of the formal institutional framework, where labour markets continue to be severely regulated and taxed. By raising labour costs, some of these regulations depress formal sector employment—especially among the low-skilled, young and female employees—pushing them to seek employment in the informal sector instead.

**2** See Ministry of Rural Development, Government of India, National Rural Employment Guarantee Act—2005, available at http://nrega.nic.in/ (accessed April 2006). The Act guarantees a minimum of 100 days of unskilled labour to every rural household at a daily wage. Eligible adult members of those households would be employed in specified public works projects, identified by local government institutions, under the scheme.

## C. Special focus: youth, women and migrants

Forty-seven per cent of all unemployed people globally are young persons.[3] Young females, furthermore, are more likely to be unemployed than males. The working conditions of young women and men could be positively influenced by improving employability through solid formal education, relevant vocational training, provision of useful labour market information and services.

Women are less likely to be in regular wage employment than men. Occupational segregation results in poor working status, affecting recruitment, earnings and promotion practices.

Wide disparities in wages and employment opportunities among developed and developing countries prompts a large flow of international migration from South to North. There is also large-scale temporary migration for work among developing countries in East, South and West Asia. Such movements generate costs and benefits for both sending and receiving nations. Labour mobility is an integral feature of a globalizing world and therefore should be the subject of international cooperation and regulation, such as now exists for the transnational movements of goods, investment and technology.

## D. Employment issues in international cooperation

Through investment, trade and information flows, international cooperation can contribute to mitigate the negative impact on employment and growth of shocks arising from financial crises, ecological fragility and terms of trade losses.

Development partners should make productive employment and decent work an integral part of growth-

3 See note 1.

enhancing and poverty-reducing strategies. Trade liberalization may generate new employment opportunities, but it may also lead to job losses and increased vulnerability. Least developed and other low-income countries need special support from the multilateral system to enable them to take advantage of opportunities to participate in global markets. Multilateral trade agreements should include provisions for social impact assessment and the promotion of decent work. Employment as a key objective must also be reflected in the programmes of the Bretton Woods institutions so that effective demand is not unduly suppressed in order to cope with external shocks.

International action through debt relief and improving donor-recipient relationships can contribute to conducive conditions for productive employment generation in least developed countries. In order to help low-income countries create jobs, developed countries should facilitate the opening of their markets to imports of goods and services in which the former have a comparative advantage, such as agriculture and labour-intensive manufacturing and services.

The Millennium Development Goals are milestones on the path towards sustainable development. By adopting them, the international community has committed itself, for the first time, to quantitative goals within a fixed timetable. Extending that approach from safe water supply and sanitation to other environmentally relevant activities may activate employment potential.

Additional resources needed to raise productive employment targets can be generated through innovative mechanisms. In the field of global environmental policy, both adaptation and compensation funds have been established or are under consideration. For instance, in a future expansion of emissions trading to include newly industrializing and developing countries, multilateral emissions trading could replace the existing bilateral

Clean Development Mechanism and could therefore lead to a substantial transfer of financial resources to the poorer countries. In this way, policies and initiatives directed towards the promotion of environmentally sustainable development may support national policies conducive to employment generation in developing countries.

## E. Recommendations for national development strategies

National policies should be targeted to give greater prominence to employment and to stimulate employment creation and growth. National development strategies should strongly enhance coherence between financial and economic policies, on the one hand, and employment, labour market policies and social development on the other. Moreover, an adequate understanding of the benefits and potential pitfalls of further opening to international trade and foreign investment is of critical importance in formulating effective national employment strategies.

A viable strategy for implementing productive employment and decent work in the poorest countries must encompass support for the traditional sectors in agriculture, small and medium-sized enterprises and microenterprises via well-conceived packages that incorporate support to introduce new technologies, microcredit to encourage expansion and support for domestic and international marketing. Policy formulation should be directed at raising productivity and facilitating the trend of diversification from agriculture to other economic activities.

New models of vocational training that stimulate training of workers within enterprises would help to match skills and demands and to strengthen working experience. Other innovative forms of training, such as exchange programmes of youth in different regions or countries, job placement schemes, counselling and legal advice, would help young people to secure decent jobs. Furthermore, employment protection legislation to ensure fairness and basic security is needed for young women workers. Working schemes to combine child-raising activities with work activities are particularly important.

In most developing countries, a vast majority of enterprises and workers are not part of the formal institutional framework. While Governments should undertake measures to integrate informal activities into the formal sector, they should also explore alternative arrangements to expand the reach of formal sector institutions. The main policy efforts in this respect should focus on promoting opportunities for access to land, finance and extension services.

# II. Coping with economic vulnerability and instability: national and international policy responses

The Committee for Development Policy reviewed policy efforts to advance growth and development, in particular those efforts aimed at building capacity for resilience to economic shocks.

## A. Economic vulnerability

The present chapter focuses on vulnerability to external economic shocks, which are outside a country's direct control. It does not consider short-term instability, conflicts or natural disasters.

Shocks are major changes in economic conditions and may include movements that are favourable, such as a dramatic rise in the price of exports, or unfavourable, such as a surge in the price of an essential import. Vulnerability to shocks is a characteristic of many developing countries, especially the least developed ones. In fact, economic vulnerability is a concept that helps to identify the least developed countries, a major task of the Committee for Development Policy (see chapter III). Least developed countries are particularly affected by external developments. The present chapter deals with dynamic vulnerability, a structural characteristic of countries, whereby shocks lead to long-term constraints on growth and development.

The ability of a country to manage dynamic vulnerability is influenced by a number of factors, inter alia, a country's size and level of development, its productive, institutional and human capacity to absorb rapid change, as well as social cohesion. Certain shocks, such as energy crises and crises emanating from upheavals in international commodity and financial markets, surpass the individual capacity of most developing countries to cope and require an international response.

## B. National responses

Over the medium to long-term, appropriate policies at the national level can help both to prevent shocks and to build the capacity to absorb the impact of external shocks more effectively. Resilience may be a natural by-product of development, but countries vulnerable to economic shocks need to create appropriate institutions to deal with such occurrences. The countries that have been successful in preventing or managing shocks have done so by adopting a long-term strategy shaped by constructive use of local knowledge and traditions. Such adaptive responses relate to several important areas of national policy.

### *1. Governance*

Nations with open and inclusive decision-making processes have been better able to build resilience and cope with the effects of shocks. Economic shocks affect different sections of society unequally and can therefore lead to political instability and civil strife. By creating an atmosphere of trust and enhancing social cohesion, good governance can foster economic stability and minimize the chances of conflict. Among other aspects of good governance, the protection of property rights has been a key to success in several countries.

Mauritius provides an example of a country that has paid special attention to the rule of law, property rights and political consensus-building. Recognizing the potential for conflict, the early independence Government developed strategies and institutions to mobilize people to seek new ways to diversify economic activities and lessen its vulnerability to shocks. Openness to dialogue and criticism have been essential aspects of conflict prevention both in Mauritius and in Botswana, leading to the emergence of a meritocracy and good governance practices across a broad range of government activities. In Botswana, economic progress has been achieved not only through enlightened leadership, but also by making good use of its traditional culture of inclusiveness. Botswana has functioned as a multiparty democracy throughout its years of independence. Perhaps equally important, civil society has played an active role in policy formation, with civil society organizations often drafting alternative policy recommendations to complement government programmes. Cape Verde has also demonstrated that political openness and participatory democracy are valuable attributes for formulating and implementing policies to overcome economic vulnerability. This approach is evident throughout the Growth and Poverty Reduction Strategy Paper that outlines the response of the Government to the challenges presented by the economic vulnerability of Cape Verde.

### 2. *Human and social capital*

To combat human suffering caused by shocks, clear and transparent rules for social assistance have to be combined with effective public programmes. In Cape Verde, the Government has launched an effort to reform the works project aimed at coping with droughts and related food shortages, using a community-based targeting system to select recipients. In Mexico, where marginal rural areas share many of the characteristics of least developed countries, shocks translate into lower capacity for future development when families choose to sell productive assets or withdraw their children from school to maintain consumption. A cash-transfer programme serves as a safety net for poor families and stimulates investment in human development as the income transfers are conditional to children attending school and mothers and infants accessing health centres. The programme should also provide families with the incentive to keep investing in the health and education of their children during periods of economic shocks.

The experience of several countries provides evidence of close links between education and resilience to shocks. In Cape Verde, growth has been based on the development of industry and services, with higher levels of productivity supported by widespread access to education. Cape Verde has already achieved 100 per cent enrolment in primary schools and the current growth strategy calls for refocusing the educational system to provide the skills required in the sectors targeted for future development. In addition to being economically vulnerable, Botswana faced independence with low levels of human assets. Starting with only a few schools in 1966, Botswana has achieved primary completion rates of more than 90 per cent for both boys and girls. But training and practice in decision-making preceded the expansion of access to formal education. The role of adult education is crucial where formulating and implementing new solutions requires broad participation. Meanwhile, the ability of civil society and opposition parties to play constructive roles in policy formation rests on the relatively high level of education of the population.

In Mauritius, both trade and industrial policies combined to reduce economic vulnerability by diversifying production and promoting foreign direct investment (FDI) in textiles and other labour-intensive industries. Clearly, policy was important, but without widespread literacy to support a political process that recognized the need for reconciliation, success would not have been possible. Moreover, strategic planning and effective implementation required that Mauritius build capacity at all levels of Government.

Expatriates can play an important role either by reversing the brain drain and thus supplementing the stock of national human resources, or through remittances. In Cape Verde, for instance, remittances constitute an important safety net. Incentives have been introduced to encourage deposits by non-residents into the banking system, thereby contributing to intermediation and eventual increases in investment, especially in the construction sector.

### *3. Fiscal and financial management*

Low-income countries (especially least developed countries) rarely have budgetary or current account surpluses. The inability to absorb adverse shocks often leads to reductions in investment in infrastructure, health and education, which compromise future growth prospects and increase economic vulnerability even more. Underdeveloped financial systems make adjustment more difficult. In turn, macroeconomic instability further undermines the health of the financial system. Cambodia and the Lao People's Democratic Republic in the 1990s provide examples of the difficulties experienced by countries lacking sufficient fiscal and monetary policy instruments to ease the adjustment. While devaluation is often recommended to correct external deficits, the experience of Mali in the 1990s indicates that it will not necessarily solve other macroeconomic imbalances in view of the sharp rise in consumer prices associated with the devaluation. This difficulty underscores the importance of careful management of a stable real exchange rate as an important tool for assuring macroeconomic stability.

These examples show the need for combining domestic and international efforts to better predict financial shocks, establish defensive mechanisms to reduce their immediate impact and bring new resources and instruments to mitigate negative consequences. The main preemptive approach would involve financial prudence and the creation of an investment climate for attracting FDI instead of relying on short-term borrowing. The "storage" of borrowing capacity through special arrangements with private financial institutions, international financial institutions and regional or international cooperation may constitute a second best alternative to stabilization reserves.

Diversification of domestic output and exports is essential to reduce economic vulnerability to changes in external demand and international prices. However, the scope for diversification is limited in small economies. In addition, a shortage of skilled labour may hinder the attempt to diversify into more skill-intensive sectors. Countries need time therefore to develop human assets. Yet their vulnerability to changes in external demand makes diversification urgent, especially when there is a slump in the prices of commodities that account for a high proportion of exports.

Developing countries that have succeeded in diversifying their economies have been able to use a combination of policies—expansion of education as well as trade and industrial policies. A combination of these polices helped, for instance, Mauritius to diversify in a range of export-processing activities and attract FDI in textiles and other labour-intensive industries.

## C. International responses

International actors—both public and private—encouraged developing countries to adopt a more open, liberal trade and financial system. While the prospect of increased flows of capital offered promise for development, capital flows often came with substantial risks. Losses from shocks to exchange rates and interest rates led to financial crises in the 1980s and 1990s. The losses were pronounced in sectors and countries that used short-term borrowing to solve longer-term problems. The international community responded to those financial crises with debt reschedulings, debt relief and efforts to coordinate financial supervision. Financial innovation and burden-sharing in the form of the Brady bonds and the initiative for heavily indebted poor countries have eased the burden of debt. For many countries, debt relief has been helpful when given in the context of poverty reduction strategies that are based on wide participation and effectively channel resources towards critical social sectors. Debt relief has proved inadequate, however, in providing sufficient resources to develop productive sectors.

International organizations now recognize the need to assist countries in their efforts to attract private equity flows needed to develop infrastructure and business activities. The Bank for International Settlements and the Financial Stability Forum are involved in efforts to strengthen financial supervision and promulgate standards and codes that enhance sound fiscal management. The World Bank and International Monetary Fund have encouraged developing countries to participate in financial sector assessments and are working with donors to provide the technical assistance needed to correct identified weaknesses. Regional organizations, such as those of bank supervisors in Latin America and eastern and southern Africa, have launched extensive training efforts to prepare bank examiners and regulators for the challenges inherent in more open economies. A regional fund in Latin America also provides access to reserves that can serve as a buffer to offset financial shocks.

Regional efforts also hold promise for broader governance reforms. The African Development Bank took the lead in discussions of governance in Africa in the late 1990s. More recently, the voluntary peer review mechanism introduced as part of the New Partnership for Africa's Development provides a context for the African Union to promote dialogue on transparency and good governance among its member States, most of which are least developed countries.

Other cases of vulnerability and instability are related to environmental stress or ecological damage. Water shortages and storm damages may intensify owing to ongoing climate change. International responses to such developments and their high economic costs have been of two types: organizations, such as various river basin initiatives, that work to prevent shortages and damage; and initiatives to guarantee safe water under the partnership efforts launched to reach the Millennium Development Goals. Under the United Nations Framework Convention on Climate Change, the international community is developing climate funds and technical assistance to assist least developed countries in responding to such vulnerabilities.

National policy efforts by least developed countries to diversify export products are often undermined by agricultural subsidies and restrictions placed on access to important markets by developed countries and by the difficulties experienced in establishing commodity stabilization funds at the international and regional levels. Stabilization funds have often been overwhelmed by the scale of fluctuations in commodity prices. In Central America, the failure of the International Coffee Agreement in 1989 led to restructuring of support funds by individual countries in the region. The success of countries, however, has rested on national efforts at research and reforms in marketing, production and distribution.

International efforts are now focusing on buffer stocks to provide relief from the immediate impact of shocks and allow time for diversification of domestic production. Along these lines, IMF recently announced an Exogenous Shocks Facility designed specifically for low-income countries (as the Committee for Development Policy suggested years ago). The assistance would be provided as a low-interest loan and would be available as insurance against shocks related to changes in commodity prices, natural disasters and conflicts.

## D. Recommendations

A few highly vulnerable countries have been able to develop the resilience required to sustain high levels of economic development and social transformation. Botswana, Cape Verde and Mauritius, for instance, have used long-term strategies that involve economy-wide interventions as well as interventions in specific, targeted sectors. Most importantly, those countries have identified and enhanced resources that provided buffers in the medium term and the "breathing space" for structural transformations that would take decades to complete. Botswana did this by building reserves from mineral sales, Mauritius by identifying the most profitable sugar agreement and Cape Verde by continuing to attract remittances. Such measures enabled them to have a financial cushion during the period of investment in education and infrastructure necessary to evolve into an economic structure less vulnerable to shocks.

The following set of recommendations identifies policy interventions that can contribute to building resilience to external shocks. The sequencing of interventions and the specific mix must be carefully tailored to the circumstances of the individual country and to the impending shifts in the global environment—both economic and environmental.

### *1. Good governance*

- Ensure the rule of law, protection of property rights, and political consensus-building.
- Increase capacity to forecast, monitor and assess risks of external shocks by developing appropriate institutions and instruments.
- Develop open and inclusive decision-making processes to mobilize stakeholders in economic recovery and development.

- Design policies that utilize existing indigenous institutions and develop mechanisms that allow for full participation of local communities, ensuring local ownership of economic and social reforms.

### 2. Human and social capital

- Ensure that economic shocks do not impede access to health care by vulnerable groups.
- Adapt education to the specific needs of vulnerable economies, incorporating local traditional knowledge and building capacities for implementation of modern technologies and democratic participation.
- Train public servants to improve administrative skills and promote democratic practices.
- Develop innovative curricula for adults and youth to develop the capacity to prevent and mitigate the impact of economic shocks.
- Create incentives for transnational migrants to invest monetary assets, skills and ideas in their country of origin.
- Develop and implement clear and transparent rules for social assistance.
- Negotiate with Governments and corporations opportunities for bilateral and multilateral cooperation in order to promote human resource sharing between the countries of origin and the countries of residence, and facilitate remittances.

### 3. Fiscal and financial management

- Combine trade and industrial policies to reduce economic vulnerability by diversifying production and exports and promoting FDI.

- Develop financial and monetary policy and instruments to ensure a stable competitive exchange rate.
- Support development of markets for equity investments to minimize the need for borrowing short-term for long-term development.
- Develop financial institutions, including different forms of microfinance as well as banks and insurance companies to provide products and services to the poor.
- Build sufficient financial reserves which could be used as a stabilization and emergency fund to mitigate the impact of serious shocks.

### *4. International*

- Encourage international efforts to develop financial exchanges in developing countries that include instruments to manage commodity price risk.
- Create the contingency arrangements for borrowing from private financial institutions and international financial organizations through regional and international cooperation.
- Establish rules for prompt disbursal of adequate financing in the case of shocks.
- Facilitate cooperation with international and regional research centres to promote research into new markets and products to support diversification.
- Support regionally focused initiatives, such as the Action Plan for Africa, with a view to addressing external shocks.
- Support proposals to establish international research initiatives on climate change that focus on developing countries.

- Reform trade and agricultural policies in developed countries, removing agricultural subsidies and trade barriers that hamper developing countries' exports.
- Improve development effectiveness by selecting vulnerable countries as candidates for assistance aimed at building capacity to manage shocks.

# III. Review of the status of least developed countries

## A. Introduction

In accordance with Economic and Social Council resolution 1998/46, annex I, paragraph 9, the Committee for Development Policy undertook a triennial review of the status of least developed countries.

Low-income countries are considered least developed if they face structural impediments to growth. Indicators of such impediments are the high vulnerability of their economies and their low level of human capital, according to the present state of knowledge on the development process. The purpose of the review is to identify low-income countries suffering from severe structural handicaps, without making a judgement on the causes of those handicaps.

The Committee, in its identification of least developed countries, considers three dimensions of a country's state of development: its income level; its stock of human assets; and its economic vulnerability. Specifically, in the review process, the Committee applies the following criteria for these dimensions, respectively: (a) gross national income (GNI) per capita; (b) the human assets index (HAI); and (c) the economic vulnerability index (EVI). In addition, in 1991, the then Committee for Development Planning, in its report on the twenty-seventh session, determined that countries with a population exceeding 75 million should not be considered for inclusion in the list of least developed countries.[4]

**4** See *Official Records of the Economic and Social Council, 1991, Supplement No. 11* (E/1991/32), para. 237. In 1991, the General Assembly, in paragraph 1 of its resolution 46/206, noted with appreciation the new criteria for identifying the least developed countries.

In the review process, the Committee determines threshold levels on each of the three criteria to identify the countries to be added to or graduated from the category of least developed countries. To be added to the category, a country must satisfy all three criteria, that is, reach the threshold levels for inclusion based on all three criteria. To become eligible for graduation, a country must reach threshold levels for graduation for at least two of the aforementioned three criteria, or its GNI per capita must exceed twice the threshold level, and the likelihood that the level of GNI per capita is sustainable must be deemed high. To be recommended for graduation, a country must be found eligible for graduation in two consecutive triennial reviews. The aim of these graduation rules is to ensure that countries in the list of least developed countries should not be graduated until their development prospects have significantly improved. The decision on whether countries should be graduated is the responsibility of the Economic and Social Council and, ultimately, the General Assembly. The Committee noted that no country is included in the list by the Assembly unless the country gives its agreement.

The Economic and Social Council, in its resolution 2006/1, took note of the recommendations of the Committee regarding general principles and the refinement of criteria with a view to achieving the objective of equal treatment of countries in similar situations and requested the Committee to continue developing a consistent set of criteria to be applied to all recommendations regarding the inclusion in and graduation from the list of least developed countries.

The 2006 review of the list of least developed countries was conducted by the Committee with due consideration for the following principles underlying the criteria, as defined by the Committee at its seventh session in 2005,[5] namely, (a) identification of low-income countries

**5** See *Official Records of the Economic and Social Council, 2005, Supplement No. 13* (E/2005/33).

suffering from severe structural handicaps; (b) equitable treatment of the countries over time; (c) stability of the criteria; and (d) the need for flexibility in applying the three criteria.

With respect to the need for flexibility, the Committee should consider, if necessary, additional information, as suggested in its report on its seventh session.[6] In order to assess the overall structural handicap in arriving at a determination for inclusion or graduation, the Committee should consider the combined level of the two structural handicap criteria (HAI and EVI).

To allow for equitable treatment and comparison of countries over time, in the construction of HAI and EVI, the Committee agreed to impose bounds on extreme outliers in the components of the indices.

## B. Criteria for the identification of the least developed countries in the 2006 review

### *1. Gross national income per capita*

The list of countries to which the criteria for identifying the least developed countries were applied during the 2006 review comprised least developed countries and developing countries classified by the World Bank as low-income countries in one of the years from 2002 to 2004. As a result, 65 countries were retained for consideration during the review: the 50 least developed countries and 15 other low-income countries which are currently not classified as least developed countries (see table below).

The threshold for inclusion was calculated at $745, a three-year (2002-2004) average GNI per capita of the low-income threshold established by the World Bank,

**6** Ibid.

based on the World Bank Atlas method.[7] The threshold for graduation was set at $900, or about 20 per cent above the threshold for inclusion, in order to effectively prevent graduating countries subsequently returning to the category owing to short-term declines in their GNI per capita caused by exogenous shocks,[8] or exchange rate variations.

### 2. Human assets index

In line with the modifications proposed by the Committee at its seventh session, the HAI used is a combination of four indicators, two for health and nutrition and two for education: (a) the percentage of population undernourished; (b) the mortality rate for children aged five years or under; (c) the gross secondary school enrolment ratio; and (d) the adult literacy rate.

As agreed in previous reviews, the HAI threshold for inclusion is the value of the index between the third and fourth quartiles of the values for the 65 countries. As in the 2003 review, the threshold for graduation was established at 10 per cent above the inclusion threshold. Thus, the threshold for inclusion in the list of least developed countries is an HAI value of 58 and the threshold for graduation is 64.

### 3. Economic vulnerability index

The EVI reflects the risk posed to a country's development by exogenous shocks, the impact of which depends on the magnitude of the shocks, and on structural characteristics that determine the extent to which the country would be affected by such shocks. In line with the modifications proposed by the Committee at its seventh session, the EVI is a combination of seven indicators: (a) population size; (b) remoteness; (c) merchandise ex-

**7** The World Bank thresholds for low-income countries during these three years were $755, $745 and $735, respectively.

**8** See note 5.

**Least developed and other low-income countries: criteria used in determining eligibility for least developed country status**

| | | | Population 2004 (millions) | Per capita gross national income (United States dollars) | Human assets index | Economic vulnerability index |
|---|---|---|---|---|---|---|
| LI | L | Afghanistan | 29.9 | 122 | 11.5 | 60.3 |
| LI | L | Angola | 15.9 | 823 | 28.8 | 43.4 |
| LI | L | Bangladesh | 141.8 | 403 | 50.1 | **25.8** |
| LI | L | Benin | 8.4 | 450 | 39.9 | 52.0 |
| LI | L | Bhutan | 2.2 | 690 | 44.4 | 46.6 |
| LI | L | Burkina Faso | 13.2 | 303 | 24.6 | 46.7 |
| LI | L | Burundi | 7.5 | 90 | 20.1 | 59.9 |
| LI | L | Cambodia | 14.1 | 303 | 46.0 | 52.3 |
| LI | | Cameroon | 16.3 | 667 | 46.7 | 33.1 |
| | L | Cape Verde | 0.5 | **1 487** | **82.1** | 57.9 |
| LI | L | Central African Republic | 4.0 | 277 | 27.3 | 50.8 |
| LI | L | Chad | 9.7 | 237 | 22.2 | 62.8 |
| LI | L | Comoros | 0.8 | 450 | 37.8 | 63.6 |
| LI | | Congo | 4.0 | 680 | 52.5 | 49.6 |
| LI | | Côte d'Ivoire | 18.2 | 683 | 41.0 | 33.5 |
| LI | | Democratic People's Republic of Korea | 22.5 | 508 | 70.3 | 40.2 |
| LI | L | Democratic Republic of the Congo | 57.5 | 103 | 21.2 | 42.6 |
| | L | Djibouti | 0.8 | **943** | 44.7 | 60.2 |
| LI | L | Equatorial Guinea | 0.5 | **3 393** | 55.6 | 70.7 |
| LI | L | Eritrea | 4.4 | 163 | 34.1 | 64.0 |
| LI | L | Ethiopia | 77.4 | 100 | 26.6 | 39.3 |
| LI | L | Gambia | 1.5 | 277 | 41.5 | 55.7 |
| LI | | Ghana | 22.1 | 323 | 56.2 | 41.5 |
| LI | L | Guinea | 9.4 | 433 | 36.2 | **34.6** |
| LI | L | Guinea-Bissau | 1.6 | 143 | 25.6 | 66.2 |
| LI | L | Haiti | 8.5 | 410 | 38.5 | 56.8 |
| LI | | India | 1 103.4 | 543 | 59.1 | 19.1 |
| LI | | Indonesia | 222.8 | 970 | 80.0 | 24.8 |
| LI | | Kenya | 34.3 | 407 | 50.6 | 24.2 |
| | L | Kiribati | 0.1 | **917** | **90.5** | 84.3 |
| LI | L | Lao People's Democratic Republic | 5.9 | 350 | 54.0 | 57.9 |
| LI | L | Lesotho | 1.8 | 623 | 61.2 | 50.5 |
| LI | L | Liberia | 3.3 | 117 | 28.9 | 68.0 |
| LI | L | Madagascar | 18.6 | 273 | 41.6 | 41.6 |
| LI | L | Malawi | 12.9 | 163 | 40.5 | 48.8 |

**Table** (cont'd)

| | | | Population 2004 (millions) | Per capita gross national income (United States dollars) | Human assets index | Economic vulnerability index |
|---|---|---|---|---|---|---|
| | L | Maldives | 0.3 | **2 320** | **81.9** | 50.5 |
| LI | L | Mali | 13.5 | 300 | 21.5 | 42.6 |
| LI | L | Mauritania | 3.1 | 403 | 46.4 | 40.6 |
| LI | | Mongolia | 2.6 | 497 | 76.8 | 46.7 |
| LI | L | Mozambique | 19.8 | 220 | 25.6 | 43.6 |
| LI | L | Myanmar | 50.5 | 167 | **68.4** | 42.2 |
| LI | L | Nepal | 27.1 | 243 | 56.0 | **37.4** |
| LI | | Nicaragua | 5.5 | 757 | 69.8 | 43.9 |
| LI | L | Niger | 14.0 | 203 | 12.7 | 50.0 |
| LI | | Nigeria | 131.5 | 347 | 50.0 | 44.8 |
| LI | | Pakistan | 157.9 | 537 | 46.2 | 25.7 |
| LI | | Papua New Guinea | 5.9 | 527 | 54.1 | 44.2 |
| LI | L | Rwanda | 9.0 | 220 | 33.8 | 59.3 |
| | L | Samoa | 0.2 | **1 597** | **90.4** | 64.7 |
| LI | L | Sao Tome and Principe | 0.2 | 333 | 63.6 | 58.2 |
| LI | L | Senegal | 11.7 | 557 | 38.8 | 41.8 |
| LI | L | Sierra Leone | 5.5 | 190 | 15.7 | 63.7 |
| LI | L | Solomon Islands | 0.5 | 557 | **70.6** | 56.9 |
| LI | L | Somalia | 8.2 | 193 | 5.4 | 68.4 |
| LI | L | Sudan | 36.2 | 463 | 49.0 | 49.9 |
| LI | L | Timor-Leste | 0.9 | 467 | 55.3 | 65.2 |
| LI | L | Togo | 6.1 | 323 | 46.0 | 45.8 |
| | L | Tuvalu | 0.01 | **1 267** | **89.7** | 91.9 |
| LI | L | Uganda | 28.8 | 253 | 49.0 | 47.4 |
| LI | L | United Republic of Tanzania | 38.3 | 313 | 32.8 | **34.1** |
| | L | Vanuatu | 0.2 | **1 187** | **66.0** | 64.3 |
| LI | | Viet Nam | 84.2 | 487 | 80.1 | 35.7 |
| LI | L | Yemen | 21.0 | 523 | 48.3 | 42.1 |
| LI | L | Zambia | 11.7 | 390 | 35.2 | 46.2 |
| LI | | Zimbabwe | 13.0 | 430 | 53.0 | 47.9 |

***Note:*** LI: low-income country; L: least developed country.

The thresholds for inclusion in the list of least developed countries are population less than 75 million; per capita gross national income (GNI) less than $745; human assets index (HAI) less than 58; and economic vulnerability index (EVI) greater than 42. A country must meet all the criteria. Thresholds for graduation from the list of least developed countries are: per capita GNI greater than $900; HAI greater than 64; and EVI less than 38. A country must meet at least two criteria to be eligible for graduation.

Figures in **boldface** type indicate a graduation criterion that has been met by a least developed country.

port concentration; (d) share of agriculture, forestry and fisheries in gross domestic product; (e) homelessness owing to natural disasters; (f) instability of agricultural production; and (g) instability of exports of goods and services.[9]

In keeping with the previous reviews, the EVI threshold for inclusion is the value of the index between the third and fourth quartiles of the values for the 65 countries. As in the case of the HAI, the Committee applied a difference of 10 percent between thresholds for inclusion and graduation. The threshold for inclusion in the list of least developed countries is 42 and the threshold for graduation is 38.

## C. Eligibility for inclusion and graduation

The 2006 review of least developed countries was conducted by the Committee in line with the general principles for the identification of least developed countries as described in section A of the present chapter and based on the threshold levels set out in section B.

### *1. Countries to be considered for inclusion*

The Committee identified three low-income countries—the Congo, Papua New Guinea and Zimbabwe—that meet all three criteria for inclusion in the list of least developed countries.

The Committee found that Papua New Guinea and Zimbabwe were eligible for inclusion. Those two countries had experienced a long period of stagnation and/or decline in their GNI per capita. Not only had they been for many years low-income countries with a low level of human capital, but they also currently met the EVI threshold for inclusion. The present HAI and EVI

**9** Ibid.

scores revealed, moreover, that they faced similar levels of severe structural handicaps to growth: when the two indices were averaged, the scores for the two countries were the same.

The Committee noted that the Congo also met all three criteria for inclusion. However, the Committee reiterated that the decline of that country, which was an oil exporter, was associated with civil war, and was considered to be a temporary rather than a structural phenomenon. In the last few years, there had been some positive developments in the country, which had brought the Congo close to the low/middle-income threshold, suggesting that it was on the path to economic recovery.[10]

The Committee noted that, among the other 12 low-income developing countries which were not least developed countries, 6 met the HAI threshold for inclusion in the list of least developed countries, while 3 met the EVI threshold for inclusion. Nigeria met the thresholds for inclusion on both HAI and EVI, but was not eligible for inclusion in the list owing to its large population (131.5 million).

### *2. Countries to be considered for graduation*

The Committee considers as eligible for graduation those countries that meet two of the criteria for the first time, and as qualifying for graduation those countries that do so in two consecutive reviews (see section A of the present chapter).

#### *(a) Eligible countries meeting the graduation criteria for the first time*

The Committee noted that Kiribati, Tuvalu and Vanuatu met two criteria for graduation: GNI per capita and HAI. While Kiribati and Tuvalu faced the highest scores in

**10** IMF Country Report No. 04/231, "Republic of Congo: Selected Issues and Statistical Appendix", August 2004.

EVI, they also showed the highest levels of HAI. Those two countries had already met the criteria in 2003, but were not considered as eligible by the Committee owing to uncertainty at that time regarding the quality of the data. In 2006, it was established that they met the criteria and so the Committee considered Kiribati and Tuvalu eligible for graduation. In the case of Vanuatu, the Committee noted that it met the GNI per capita and HAI criteria. Although Vanuatu still had a very high EVI score, the Committee considered Vanuatu eligible for graduation. The Committee recommended that information be collected on the situation of those three countries before the next triennial review in order to allow a fully informed in-depth assessment.

Equatorial Guinea had a GNI per capita of about $3,400, the highest among the least developed countries, almost at four times the graduation threshold, which placed it among the higher middle-income group of countries. Although Equatorial Guinea did not meet any other required threshold for graduation and it was highly vulnerable as measured by the EVI, the Committee, in line with the recommendation previously adopted at its seventh session, found Equatorial Guinea eligible for graduation. The Committee also noted that the level of HAI in that country had improved since the previous review, becoming closer to the graduation threshold: 56 for a graduation threshold of 64 in 2006, compared to 47 for a graduation threshold of 61 in 2003.

*(b) Countries qualifying for graduation (meeting the criteria for two consecutive periods)*

In 2003, the Committee found Samoa eligible for graduation. The 2006 review confirmed that Samoa had met two graduation criteria (GNI per capita and HAI). Samoa now has the third highest GNI per capita and the second highest HAI score among the least developed countries; both measures are well above the graduation threshold. However, Samoa is economically vulnerable, with an EVI score of 64.7, far greater than the graduation threshold of 38. The average of the two indices, HAI and EVI, is at a level similar to that of Cape Verde, whose graduation has been decided by the General Assembly. The Committee considered the vulnerability profile prepared by UNCTAD, which confirmed the strong dependence of the economy on remittances and provided an assessment of the likely consequences of graduation for Samoa (see http://www.un.org/esa/policy/devplan/pastmeetingscdp.htm). The Committee was also given a presentation on the situation of the country by the Ambassador of Samoa. Taking into consideration the whole set of information, the Committee recommended Samoa for graduation from the list of least developed countries.

### 3. *Other issues*

In its review, the Committee noted that of a total of 50 least developed countries, 36 countries failed to meet any of the graduation criteria, while 7 other countries met no more than one of the three graduation criteria. Of the remaining seven countries, two were to be graduated in accordance with recent General Assembly resolutions[11] (Cape Verde at the end of 2007 and Maldives in January 2011), one was recommended for graduation (Samoa) and four were found eligible for graduation for the first time by the Committee at the eighth session (Equatorial Guinea, Kiribati, Tuvalu and Vanuatu).

The Committee informed the representatives of those countries that were found eligible for inclusion in the list of least developed countries (Papua New Guinea and Zimbabwe) and countries considered eligible for graduation from the list (Equatorial Guinea, Kiribati, Tuvalu and Vanuatu). The Committee was subsequently notified by the Government of Zimbabwe that Zimbabwe "does not

**11** See General Assembly resolutions 59/209, 59/210 and 60/33.

give its consent to be downgraded to LDC status".[12]

## D. Implementation of transition strategy and post-graduation monitoring

The Committee was informed by the Ambassador of Cape Verde of its transition strategy. The Committee noted that the country was decisively taking ownership of the graduation process in a participatory manner.

The Committee affirmed its willingness to monitor the implementation of the transition strategy of all graduating countries, in accordance with paragraph 12 of General Assembly resolution 59/209.

## E. Recommendations

The Committee recommended that: (a) Papua New Guinea be included in the list of least developed countries (subject to the Government's acceptance); and (b) Samoa be graduated from the list of least developed countries.

The Committee found Equatorial Guinea, Kiribati, Tuvalu and Vanuatu eligible for graduation for the first time. It expected UNCTAD to prepare vulnerability profiles for those countries in accordance with General Assembly resolution 59/209. The Committee was amenable to providing guidance for the preparation of the profiles.

In that year prior to the next triennial review (2009), the Committee should make an effort to identify the countries which were likely to be recommended for inclusion or graduation in order to facilitate timely and in-depth collection of data on those countries.

The Committee considered that there was scope

**12** Letter (dated 30 March 2006) from the Secretary for Foreign Affairs of the Republic of Zimbabwe, Ambassador J.M. Bimha, addressed to the Secretary of the Committee for Development Policy.

and need for further methodological refinements in the design and application of the criteria. In particular, it was of the view that owing to the incidence of HIV, the life expectancy at birth should be used as a component of HAI, as soon as reliable data became available.

With regard to the large number of least developed countries which so far did not meet any of the criteria for graduation and were not likely to meet the Millennium Development Goals, the Committee recommended that priority attention be given to those countries in order to design appropriate policy interventions.

The Committee suggested that the graduating countries be assisted in obtaining information about the range of development assistance available to implement a smooth transition.

Annex

# Policy responses to economic vulnerability[a]

## Background

This study reviews policy efforts to advance growth and development in the least developed countries, in particular those efforts aimed at promoting well-being by reducing vulnerability to economic shocks. The paper draws on empirical research analysing the relationships among economic vulnerability, growth and policy. The analysis rests on the concept of *dynamic vulnerability*, a tendency to experience shocks which, in addition to producing immediate welfare losses, depress longer-term growth and development (Guillaumont, 2006, chap. VI, pp. 5-6). Patrick Guillaumont and others provide evidence that policy is not exogenous in the vulnerable environment. Rather, the ability to design and implement effective policy is negatively influenced by the level of economic vulnerability of a particular country. In this context, aid allocations would not be given as a reward for good policy, but would be given both to compensate for shocks and to support the ability to design and implement an effective policy response (Guillaumont and Chauvet, 2001, p. 66). Understanding the policy implications of economic vulnerability thus emerges as critical to both aid effectiveness and sound domestic policy management.

Given that domestic policy efforts are weakened by the shocks that characterize vulnerability, the international community has an important role to play in countries' efforts to cope with economic instability. The

**a** The present paper was prepared by Ms. Willene Johnson, member of the Committee for Development Policy, as a background paper for deliberations by the Committee at its eighth session. The author is an independent economist. The paper benefited from comments by Le Anh Tu Packard.

present paper begins with an assessment of certain international efforts to mitigate economic vulnerability and focuses on how these efforts may have reduced the likelihood of systemic shocks as well as on how they may have enhanced the resilience of individual countries with regard to shocks. The second part of the study examines how certain countries have used domestic policy instruments to mitigate and contain the economic risk factors that contribute to vulnerability and insecurity. The concluding section draws on the range of international and domestic policy responses with a view to identifying those interventions that have been successful or that show promise for promoting future development.

The present paper does not explore issues related to conflict or the environment, yet it is clear that development can only be sustained when war and natural disasters are held at bay. These topics were omitted not because they are unimportant, but because they are too important and would be worthy of a more comprehensive treatment.

## International efforts to mitigate economic vulnerability

Vulnerability has been defined as "the risk of being negatively affected by shocks". While some of the most devastating shocks are caused by natural disasters, countries can also be struck by "economic shocks that are outside of their control, such as a rapid decline in the price of their major export, changes in interest rates on international capital markets or reduced access to credit" (United Nations, 1999, para. 38).

The financial crises of the last two decades provide vivid examples of economic shocks. These financial upheavals, notably in Latin America in the early 1980s and East Asia in the 1990s, resulted in dramatic economic downturns, political upheavals and bleaker prospects for longer-term growth and development. The various financial disruptions shared certain characteristics. In each case, countries experienced large inflows of private capital that quickly turned to outflows when creditors' perceptions shifted. During the late 1970s and early 1980s, private capital flows to Latin America took the form of bank loans. While sovereign borrowers often benefited from longer-term credits from bank syndicates, most private-sector borrowing was in the form of short-term loans for trade finance and working capital. With sharp increases in United States dollar interest rates, the costs of servicing these variable-rate loans to both public and private borrowers rose sharply at a time when export earnings faltered.

In part due to these shocks, the Latin American countries faced macroeconomic imbalances, including growing current-account deficits and a large external financing gap. Initially, the international policy response was to treat each country on a case-by-case basis, with the International Monetary Fund (IMF) taking the lead and providing a lending programme to cover the immediate financing shortfall. Donor countries offered to reschedule official-source debt in the Paris Club, and private-sector bankers met under the auspices of the London Club to offer debt rescheduling and refinancing with new money. These London Club gatherings recognized the importance of maintaining exports from the borrowing country, and arrangements were often accompanied by commitments to keep trade-financing lines available. Most of the affected countries "muddled along" for some years, facing repeated reschedulings and a shortfall in financing that hampered growth. Programmes with the IMF were extended for years and included conditions related to structural adjustment that Latin Americans viewed as onerous, in large part because constraints on public spending often appeared to have a detrimental impact on the poor, and the prescription of devaluing exchange rates and raising interest rates led to business failures and discouraged investment needed for future growth.

The Latin American debt crisis highlighted the need for stronger banking regulation and supervision. Banks in Latin America began a reform process that continues today, but banks in the United States of America and other developed countries also became the focus of efforts to improve risk management and supervisory oversight. The Bank for International Settlements (BIS), which played a coordinating role in the debt restructurings, was also the venue for meetings of the Basel Committee on Banking Supervision, which comprised bank supervisors from the Group of Ten industrialized countries. In 1988, the Basel Committee agreed to a framework for measuring capital adequacy and defined a minimum capital standard for internationally active banks. Based on consultations that included supervisors from several large developing countries, the Basel Committee later made recommendations related to banking supervision issues and in 1997 published the *Core Principles for Effective Banking Supervision* (see United Nations, 2001a, p. 145). Despite these efforts to strengthen the financial system, the burden of debt and the demands of serial reschedulings weighed on the economies of Latin America.

The introduction of Brady Bonds in 1989 helped to revive the financial and economic outlook for Latin America. Brady Bonds securitized the outstanding bank loans into instruments that incorporated both debt forgiveness and rolling interest guarantees. These innovations allowed the middle-income countries of Latin America to return to the financial markets and presaged the combination of burden-sharing by lenders and financial innovation that were to be important for later debt-relief efforts aimed at assisting the poorest countries.

However, financial innovations could not prevent future financial crises. Financial difficulties emerged again in the 1990s and, while the precipitating events differed, the extent of the disruptions in various countries, including Mexico, the Russian Federation and several countries in East Asia, pointed to the need for additional financial sector reforms in middle-income countries.

These financial crises involving middle-income countries also created economic shocks in poorer countries, in part because recessions in the crisis countries led to a sharp fall-off in demand for least developed countries' exports, but also because the heightened risk awareness slowed capital flows to nearby countries. For example, Cambodia and the Lao People's Democratic Republic, the poorest countries in East Asia, both suffered economic downturns related to the East Asian financial crises that struck Thailand, Indonesia and the Republic of Korea. The path of contagion was sometimes obvious—the Lao currency was closely linked to the Thai bhat and thus fell more than 70 per cent against the United States dollar between July 1997 and June 1998. The resulting rise in inflation led to dramatic declines in real incomes and purchasing power, especially among the poorest populations (Okonjo-Iweala and others, 1999, p. 49). Other means of contagion were less obvious, such as the pullback in foreign investments. Flows of foreign direct investment (FDI) into the Lao People's Democratic Republic and Cambodia declined sharply during the same period.

In view of the suffering caused by financial shocks, international organizations faced growing pressures to help developing countries design and implement financial reforms that included appropriate regulatory structures. In 1999, the World Bank and the IMF launched the Financial Sector Assessment Program aimed at providing thorough reviews of the domestic financial systems of member countries. The reviews, along with a related exercise of reviewing compliance with international standards and codes, serve to identify vulnerabilities in financial systems, analyse how countries manage the risks that they face and identify needs for technical assistance to develop institutional capacity. Work on standards and codes is being done under the auspices of the Financial Stability Forum, using codes promulgated by several standard-setting bodies.

Efforts at financial reform have also benefited from the work of a new international forum, the Group of 20 (G-20). The G-20 includes central bank governors and finance ministers of several systemically important emerging market countries in addition to representations of the major industrial countries. The G-20 has proven to be a useful forum for discussion on restructuring international financial relations. When others failed to make progress on developing a sovereign debt restructuring mechanism proposed by the IMF, the G-20 advanced action on a related issue, the introduction of collective action clauses in international bond agreements that outlined procedures in the event of payments problems.

The poorest countries are not represented in the groups described above and thus must continue to press for greater influence in the IMF and the World Bank to ensure that their needs are taken into consideration in the ongoing reform initiatives. In late 2005, the major international financial institutions (IFIs) introduced several programmes aimed at lessening the economic and financial vulnerability of the poorest countries. In December 2005, the IMF announced that it would grant 100 per cent debt relief for 19 countries under a new programme, the Multilateral Debt Relief Initiative. This new programme is being conducted jointly with two other IFIs: the International Development Association (IDA), the "soft window" of the World Bank Group; and the African Development Fund (AfDF), the counterpart to IDA in the African Development Bank Group.

The need for substantial debt relief for poor countries is an imperative that was first articulated nearly 20 years ago in the 1987 United Nations Conference on Trade and Development (UNCTAD) Trade and Development Report (see Jolly, Emmerij and Weiss, 2005, p. 56). Early efforts at official reschedulings for poor countries proved insufficient, even though Paris Club reschedulings started in 1956 and half of outstanding developing-country debt was included in reschedulings during the 1960s and 1970s (United Nations, 2005, p. 142). The international community, both at the official and non-governmental levels, long recognized that the debt burden of the poorest countries was a threat to growth and development, but the extent of debt relief was limited by restrictions in the charters of the IFIs, which precluded rescheduling of their loans. The programme of debt relief for the Heavily Indebted Poor Countries (HIPC), introduced in 1996, involved the innovation of creating a trust fund to provide the payments originally due the IFIs.

The HIPC Initiative also introduced the concept of sustainability as a criterion for determining the amount of relief that a country should receive. The programme assumed that large debt-service payments that drew finances away from essential services were not sustainable. Countries involved in the Initiative were required to develop poverty reduction strategies and to show evidence of making efforts towards improving governance and ensuring macroeconomic stability. Although the HIPC Initiative was path-breaking, the amount of debt relief proved insufficient for true sustainability. In response to repeated pressure from civil society and advocates for the poor, the Enhanced HIPC Initiative was introduced in 1999 to provide broader and deeper debt relief. By April 2005, 27 countries had received debt relief, resulting in a reduction of debt stocks of about two thirds (United Nations, 2005, p. 145), with much of the savings from lower levels of debt servicing being directed towards social sectors and other poverty-reduction activities. Nevertheless, the amounts of debt relief involved in the enhanced Initiative left some countries still short of long-term debt sustainability, in part because commodity price shocks for coffee and other least developed countries' exports had sharply reduced export earnings and related capacity to service external debt.

The Committee for Development Policy called for greater debt relief and an increased share of official development assistance (ODA) in the form of grants to limit the growth of future indebtedness (United Nations, 2004, p. 7). The Committee emphasized that debt relief, though essential, could not be the basis for future development and called for "fresh resources" in the form of higher levels of ODA, and also stressed the need for investments in infrastructure and productive sectors such as agriculture and industry (United Nations, 2004, p. 7).

During the past few years, advocates for more effective development assistance have supported efforts to increase ODA flows and have introduced measures to improve aid effectiveness and build capacity to design and implement policy. Several donors, especially those in Europe, have advocated aid in the form of budget support in order to dampen the volatility of flows and release least developed countries from the burden of devoting time and resources to reporting on donor-funded projects. Others have recommended that aid flows be designed to counter shocks directly, either by tying debt-servicing levels to exports or releasing grants to offset losses related to shocks (Guillaumont and others, 2003, p.8).

The IMF recently announced that it was establishing an Exogenous Shocks Facility designed specifically for low-income countries. The assistance would be provided as a low-interest loan (not a grant, as recommended by Guillaumont) and would be available as insurance against shocks related to changes in commodity prices, natural disasters and conflicts. The programme is designed to make quick disbursements and seek repayment within one or two years. An earlier IMF programme, the Compensatory Financing Facility (CFF), had been specifically designed to compensate for commodity price fluctuations, but fell out of use, in part because it was viewed as too expensive. The CFF may also have been too slow, and Guillaumont noted that both the CFF and the European Stabex facility failed to release funds automatically, thus losing the beneficial effect of immediate, counter-cyclical compensation (Guillaumont and others, 2003, p. 5).

International efforts to mitigate economic vulnerability have included various international price-stabilization or commodity agreements. Nearly all of the agreements collapsed because of financial or organizational problems. The best-known arrangements include the International Sugar Agreement (entered into force in 1954; lapsed in 1984 with the expiration of export quotas), the International Tin Agreement (entered into force in 1954; collapsed in 1985 when resources for buffer stock were exhausted) and the International Cocoa Agreement (entered into force in 1972; suspended in 1989 after export quotas were allowed to expire). The International Natural Rubber Agreement remained active through 1999, and several economists concluded that the relative success of the rubber agreement rests on the fact that this commodity experiences short-lived shocks. According to their analysis, shocks that take a long time to reverse are unlikely to benefit from price stabilization schemes (Cashin, Liang and McDermott, 1999; Cashin and Pattillo, 2000).

The least developed countries continue to receive an array of benefits granted by the international community. The list of benefits from multilateral organizations includes non-reciprocal preferences, exemption from the obligation to reduce trade barriers and favourable treatment for certain least developed countries' exports (for a complete list, see United Nations, 2002, annex II). Certain groups of least developed countries also receive significant benefits defined in bilateral arrangements, such as the benefits of free entry for a wide range of goods offered by the United States to 37 African countries under the African Growth and Opportunity Act (AGOA). In a recent study, the United States identified major challenges to export growth in AGOA countries. Although the focus of the study was on the significant domestic barriers within African countries, the report also noted that international barriers to trade growth include barriers to greater intraregional trade, high tariffs and other trade-distorting measures, and non-tariff barriers that include complex rules of origin (Office of the United States Trade Representative, 2005, pp. 2-3). Thus, despite the significant benefits granted by the international community, most least developed countries have not been able to diversify trade in a way that would increase their export earnings or dampen swings in export earnings.

The failure of programmes designed to dampen the impact of commodity price swings and the failure of countries to diversify export earnings may be critical obstacles to development in the least developed countries. Guillaumont points out the macroeconomic consequences of unstable international prices. When such price swings lead to instability in export earnings, they become an important factor responsible for instability in the real exchange rate, thus disrupting signals about long-term trends and leading to poor resource allocations and lower factor productivity (Guillaumont and others, 2003, p. 3). A study by Frenkel and Taylor (2005, p. 2) lends analytical support to the importance of exchange-rate management for resource allocation and economic development. From a policy perspective, Frenkel and Taylor note that management of a stable real exchange rate, combined with industrial policies, can be used to enhance overall competitiveness and boost productivity and growth. Empirical evidence supporting the use of exchange-rate targeting as a development instrument is presented by Le Anh Tu Packard (2005) in a study of Viet Nam. Packard emphasizes the effectiveness of this macroeconomic policy framework, recommending targeting the real exchange rate rather than targeting inflation because the real exchange rate exerts influence on the allocation of labour and capital and on the composition of domestic output. In Viet Nam, movements in the real exchange rate appear to have a significant impact on the composition of employment, particularly the allocation between low-productivity agriculture and higher-productivity employment in various sectors of formal employment.

The work of Frenkel, Taylor and Packard has furthered our understanding of the challenges of macroeconomic policy management for countries making the transition to market economies. More work is needed to understand the specific challenges faced by least developed countries in developing both the policy framework and instruments to assure macroeconomic stability and growth. While the IMF has demonstrated special efforts in the area of assistance to poor countries, introducing a new non-borrowing programme called the "Policy Support Instrument", the ability of the Fund to support policy management in low-income countries will depend on continued progress in understanding the special challenges of least developed countries and on developing a policy framework and instruments for implementing monetary and fiscal policies that support the process of the structural change critical for the poorest countries to begin a sustainable path to development.

## National responses to economic vulnerability

National policy responses to economic shocks are critical instruments in poverty reduction. Following the guidance of Amartya Sen (1999, p. 360), we view poverty as not simply a low income, but rather as "a serious deprivation of certain basic capabilities". From this perspective, effective policy and planning should enable a country to reduce its vulnerability to the impact that shocks have on growth and development. Within a more immediate timeframe, policy actions and instruments should be designed to mitigate the impact of current shocks. International assistance, though helpful in relieving the immediate impact of a shock, would be viewed as unhelpful if it disrupted community decision-making and collective activity that might provide long-run or future protection from economic risk (Barrett and Maxwell, 2005, p.185).

The range of national policy choice will be shaped not only by international actions such as those described in the previous section, but by the political, social and economic realities of the individual country. Most importantly, the national responses will be conditioned by the impact of economic shocks at the household level and the range of options that households have to mitigate the impact of shocks. Ongoing work on the empirical effect of shocks on poor economies was recently published in the special issue of the *Journal of African Economies* (2005) on "Risk, Poverty and Vulnerability in Africa". Both theoretical and empirical research on responses to economic shocks at the household level provide useful frameworks for national policy responses (see Dercon, 2005; and the collection of papers on consumption smoothing by Anne Case and others in the *Journal of Economic Perspectives,* 1995).

Understanding the household response to shocks can guide interventions that target poverty reduction. In Mexico, a cash transfer programme has proven effective in encouraging poor families to maintain their children's school enrolment in spite of economic shocks, thus promising an increase in future growth and development in poorer areas. Recent studies also underscore the importance of maintaining the broad development policy objectives related to health and education. That the death of the head of household or spouse ranked just behind drought as the second most significant cause of loss of assets, income or consumption in rural Ethiopia (Dercon, Hoddinott and Woldehanna, 2005) makes clear that improving public health systems is a critical aspect of development and a way of diminishing shocks and their long-term impact. Better access to health services obviously improves performance on the health-related Millennium Development Goals (child mortality and maternal health), but improved health and its related productivity also have a significant impact on the first and foremost of the Millennium Development Goals—reducing poverty and hunger.

### *National responses: the experience of least developed countries*

Although the least developed countries experience shocks more often than other developing countries, such repeated experiences do not lead to a more effective response. Rather, the experience of a shock can actually weaken capacity for subsequent response and can increase economic vulnerability. Often, the inability to finance the adjustment to a shock leads to additional borrowing, thereby reducing the opportunity to invest in infrastructure or health and education systems. In reviewing the responses of Cambodia and the Lao People's Democratic Republic to the financial crises of the late 1990s, it was evident that the policy response in each case was halting and painful. Like many least developed countries, Cambodia and the Lao People's Democratic Republic lacked the range of fiscal and monetary policy instruments needed to ease the adjustment. Expenditure cuts were the primary means of balancing fiscal accounts, and difficulty in controlling inflation extended the erosion of real incomes, especially among the poor (Okonjo-Iweala and others, 1999, p. 50). Restoring macroeconomic balance was particularly difficult in the Lao People's Democratic Republic, where the Government removed direct instruments of monetary control before completing the design and implementation of indirect instruments. Financial-system weakness made the adjustment more difficult and the inflationary pressures further undermined the health of the banking system. Cambodia's adjustment was challenging because the country still felt the impact of the natural disasters of 1994 that destroyed 20 per cent of the rice crop. Although both economies have since recovered, progress on eliminating poverty has slowed or even reversed, with the overall brunt of the shocks being borne by the poorest populations in each country.

Designing and implementing appropriate responses to commodity price shocks have also proven difficult for poor countries. Historically, many developing countries, especially those in Africa, relied on marketing boards to dampen the impact of commodity price swings on incomes of small producers. In West Africa, Mali employs a State-owned enterprise to ease the economic dislocations associated with wide swings in earnings from cotton, a major export. The government-controlled company is the monopoly purchaser of cotton, providing a base price along with substantial premiums in years when prices are higher. For Mali, the 25 per cent decline in world cotton prices in 1992 resulted in a large loss of export income. Cotton exports had accounted for nearly half of total export earnings prior to the price decline, and prices stayed at the lower level through 1993 before rebounding sharply in 1994. Although cotton accounted for only 6 per cent of gross domestic product (GDP) prior to the shock, about 1.5 million rural residents out of a total population of 9.2 million depended directly on cotton. The cotton-purchasing company estimates that income for cotton farmers fell only 2 per cent in 1992, as producers continued to receive the agreed floor price (but not the premium). However, incomes declined by more than 11 per cent in 1993, and the decline accelerated to 16.4 per cent in 1994 (International Monetary Fund, 2003, Annex I).

The other official response to the deterioration of the Malian current account was a 50 per cent devaluation in the national currency, the Communauté financière africaine (CFA) franc. The devaluation was actually a regional rather than a national response, since the currency is managed by a regional central bank in coordination with national authorities from West African member countries along with the French Treasury. The devaluation came in response to a widespread deterioration of external accounts throughout the CFA franc zone and, in each case, led to local producers' receiving a higher return in local currency terms for their commodity exports. Nevertheless, the gain in real income for cotton farmers in Mali was wiped out by the sharp rise in consumer prices associated with the devaluation. The lack of local—or even regional—sources for many essential goods meant that the loss of external purchasing power from the devaluation passed through quickly to goods sold on the local market. This difficult adjustment underscores the importance of careful management of a stable real exchange rate as an important tool for assuring macroeconomic stability.

Mali and other cotton-producing countries were recently hit by another economic shock when world cotton prices plunged to record lows during 2004, with the euro price declining by nearly 40 per cent, owing primarily to a record world harvest that had been stimulated in part by production subsidies in higher-income countries. The producer price for the crop was set in April-May 2004, when world prices were still near the peak. In Mali, with ongoing public control of both ginning and marketing, the central Government is absorbing more than half of the projected losses, the total budget subsidy amounting to 1 per cent of GDP. (International Monetary Fund, 2005a, pp. 14-15; International Monetary Fund, 2005b, pp. 13-14). Although donor grants have helped ease the adjustment, there appears to be little improvement from the policy response to the previous price shock. The ability of Mali to diversify exports and other economic activity is limited at least in part by shortages of the skilled labour required for more skill-intensive sectors (Office of the United States Trade Representative, 2005, p. 21-24). The challenges faced by Mali underscore the link between the two dimensions that characterize the least developed countries—a low level of development of human assets and a high level of economic vulnerability. Nevertheless, diversification into other sectors would be easier if Mali and the other least developed country cotton exporters (Benin, Burkina Faso and Togo) were not faced with a market distorted by the generous subsidies given to cotton producers in the United States and other wealthy countries. Although the elimination of all such trade-distorting support is a stated aim of the ministers participating in the Doha Round of trade negotiations, the Sixth Ministerial Conference of the World Trade Organization in Hong Kong Special Administrative Region of China ended in December 2005 with no specific agreement as to the timing and pace of such elimination.

### *National responses: the experience of middle-income countries*

Mauritius was once used as an example of impending economic catastrophe. In the 1960s, economists lamented that rapid population growth and a monocrop economy vulnerable to destruction by storms would combine to produce economic misery. Furthermore, ethnic tensions appeared to threaten social strife. Today, Mauritius is praised as an economic success. Economic growth has averaged nearly 6 per cent a year since the early 1970s. Unemployment—once around 20 per cent—declined rapidly to around 3 per cent by the late 1980s; firms now complain of labour shortages.

What were the keys to success in Mauritius? Some economists credit the policy response. Both trade and industrial policies were combined to reduce economic vulnerability by diversifying to a range of products in export processing zones that promoted FDI in textiles and other labour-intensive industries. Clearly, policy was important, and targeting development in areas where the country had assured market access was critical. However, other countries have tried to establish export processing zones and failed. Perhaps, in the case of Mauritius, institutions were important and widespread literacy helped to support a political process that recognized the need for reconciliation. Some economists (Subramanian and Roy, 2001) think that Mauritius was able to use diversity as a source of strength. Recognizing the potential for conflict, the early independence Government paid special attention to the rule of law, property rights and political consensus-building. And thus a country with many disadvantages, including the geographical disadvantage of a relatively remote location, was able to use strategy and institutions to respond to the new global pressures and the ever-present shocks to sugar production caused by storms and unpredictable weather.

Mauritius will face a new challenge in lower sugar prices because of the preference erosion that is likely to result from the Doha Round, but the country and its private sector are putting in place a strategy to respond to this impeding shock. Mauritian sugar producers are already moving towards specialty sugars that will continue to earn a higher price, and the economy as a whole continues to develop greater employment in service exports, including tourism and information and communications technology. By making secondary education mandatory until the age of 16, the Government of Mauritius hopes to encourage the development of human capital needed for the expanding high-skilled service activities (Office of the United States Trade Representative, 2005, pp. 80-81).

Although Mexico is a middle-income country, the marginal rural areas—which are subject to various climatic shocks that reduce income—have many of the characteristics of least developed countries. In these areas, shocks translate into lower future growth and development when families choose to sell productive assets or withdraw their children from school to maintain consumption. Interruptions in school attendance often lead to permanent withdrawal from school and result in lower levels of skills and productivity. The PROGRESA programme provides a cash transfer to poor mothers who can demonstrate regular use of local health facilities and regular attendance of children in school. The transfer increases as children attain the secondary grades. A recent study indicates that the cash transfer programme has been able to serve as a safety net for poor families, enabling children to maintain enrolment despite economic shocks related to drought, natural disaster or illness. Moreover, the general health of PROGRESA villages was better than that of other villages, indicating an immediate benefit as well as the longer-term advantage of higher levels of school enrolment (de Janvry and others, 2005).

Domestic resource mobilization is often seen as an essential buffer against the financial shocks that threaten developing countries. On a household level, microfinance institutions that offer savings and insurance (as well as credits) allow families to maintain consumption in the face of shocks, without their having to sell livestock or other productive assets. Providing microfinance through commercial institutions provides a model for financial services to the poor that is sustainable and less subject to swings in ODA or government finance (Robinson, 1998, p. 391). In South Africa, the Government has played a leadership role in encouraging the private sector to supply a range of services to the poor. The South African Government developed a "financial sector charter" that provides a blueprint for inclusion ("deracializing" the financial sector in terms of ownership, employment and procurement practices and setting specific targets for improvement in financial access). The charter was signed in October 2003 by the Government, representatives of financial services, such as banks and insurers, and representatives of the labour movement and other parts of civil society. Banks and insurers made a commitment to provide certain products and services to the poor by 2008. In a first step, the major banks and the Postbank created a new entry-level bank account, drawing in 1.3 million new customers in the first nine months. Participants in the South African arrangement are now encouraging other African countries to develop a strategy for creating an inclusive financial sector and to embed commitment to this strategy by all stakeholders in a formal financial access charter (Napier, 2005, pp. 8-9).

### *National responses: experiences in transition*

Only one country, Botswana, has successfully graduated from the list of least developed countries as defined by the United Nations. Two other countries, Cape Verde and Maldives, have been recommended for graduation, but the transition period for Maldives was postponed for three years because of catastrophic losses associated with the Indian Ocean tsunami of December 2004. The experiences of Botswana and Cape Verde, though limited, are instructive. What were the national policies that allowed these two countries to overcome the structural disadvantage of their vulnerable, unstable environment?

Both Botswana and Cape Verde are countries characterized by high levels of economic vulnerability; the current assessment of Cape Verde, with an economic vulnerability index of 55.5, places it among the top ten least developed countries in terms of vulnerability. In addition to being economically vulnerable, Botswana faced independence with extraordinarily low levels of human assets. At the time of independence in 1966, there were only two secondary schools in the entire country and only one quarter of the 1,000 civil servants were Batswana. The physical disadvantages of Botswana were readily evident: it was a large country (581,700 square kilometres) with only a few kilometres of road and 4 per cent arable land, landlocked, and surrounded by hostile neighbours. Nevertheless, economic progress began almost immediately, owing to the informed leadership of its first President, Sir Seretse Khama, and also because the traditional culture of its major ethnic group was inclusive (absorbing other groups as political and social equals) and open (where debate and discussion were encouraged). Thus, Botswana has functioned as a multi-party democracy throughout its years of independence. Perhaps equally important, civil society has played an active role in policy formation, with civil society organizations "drafting parallel programmes and implementation methodologies that complement rather than rival those of the state" (Maudeni, 2004, p. 623).

The ability of civil society and opposition parties to play constructive roles in policy formation rests on the relatively high level of education in Botswana. Starting with only a few schools in 1966, Botswana now boasts primary completion rates of more than 90 per cent for both boys and girls. But training and practice in decision-making preceded the expansion of access to formal education. At a speech at Cornell University in October 2005, the second President of Botswana, Ketumile Masire, described the participatory process that led to the decision to share mineral wealth throughout the country. This process involved all of the chiefs in the country and the decision on sharing resources was made before any such resources were identified. By the time mining companies discovered minerals, a social contract on sharing resources was in place. President Masire also described how the Government conducted regular surveys to determine the progress of each crop cycle. Local and national governments work together to create an early-warning system that facilitates a timely response to food shortages and other economic problems associated with the recurrent droughts that characterize the climate of Botswana.

Inclusiveness and openness to criticism have been essential aspects of conflict prevention in Botswana and have fostered a meritocracy and good governance across a broad range of government activities. Several economists conclude that the protection of institutions of private property has been the key to success (Acemoglu, Johnson and Robinson, 2003). There is no doubt, however, that the sound financial management in the Government and the central bank has also been a critical factor, assuring macroeconomic stability with low inflation and a stable, competitive real exchange rate against major trading partners (Commission for Africa, 2005, p. 355-356).

Cape Verde has also demonstrated that political openness and participatory democracy are valuable attributes for formulating and implementing policies to overcome economic vulnerability. This approach is evident throughout the Growth and Poverty Reduction Strategy Paper (GPRSP) that outlines the response of the Government of Cape Verde to the challenges presented by the country's economic vulnerability. This vulnerability relates in part to its status as a small island developing economy, but is most evident in the fragile environmental situation of the archipelago. Only 10 per cent of the land in Cape Verde is arable, and planting on hillsides has been done in ways that contribute to greater soil erosion. Rain is limited and sporadic, and the process of desertification, well known in the West African Sahel, is also under way in Cape Verde. Despite the challenges of a harsh environment, Cape Verde has demonstrated high rates of economic growth since independence. Much of the growth has been based on the development of industry and services, with higher levels of productivity supported by widespread access to education. Cape Verde has already achieved 100 per cent enrolment in primary schools, and the current growth strategy calls for refocusing the educational system to provide the skills required in the sectors targeted for future development.

Poverty in Cape Verde is more common in the rural areas and intensifies during periods of drought. The national policy response to economic shocks of this type has been to provide a government works programme that functions as a safety net in the rural areas. While the primary aim of the programme is to provide food security for the rural poor, the projects include work on road construction, soil and water conservation, and reforestation programmes. Such projects aim to limit the consumption effect of the shock while building structures to make future shocks less likely.

The public works programme has been criticized in terms of the design of its projects as well as the selection of participants. In response to these concerns, the Government has launched an effort to reform the works project, using a community-based targeting system to select recipients. The reform would also restructure the institutional framework responsible for designing, managing and monitoring the activities of the works programme. Participants in the oversight arrangement would include representatives of the central Government, local authorities and civil society representatives, such as farmers groups and non-governmental organizations. The GPRSP recognizes the need to improve the employability of the participants and to forge better links with the labour market.

The other important safety net comes in the form of remittances from Cape Verdeans working overseas. Remittances provide 11 per cent of the total income for rural areas and are an important cushion against drops in consumption when rural areas are hit by drought or other economic shocks. Cape Verde has introduced incentives to encourage deposits by non-residents into the banking system, contributing to intermediation and eventual increases in investment, especially in the construction sector. Additional flows of remittances into the formal financial system would provide multiple benefits by increasing resource mobilization and intermediation. Gaining a better understanding of the incentives that promote remittance flows would provide the Government with greater confidence in its financial management, since the Government currently views both remittances and ODA as significant sources of external financing that remain outside of its control.

## Key policy responses to economic vulnerability

How can the least developed countries develop and sustain the capability to provide health and economic well-being for their populations? Can this capability extend to periods of economic shock in ways that lessen the likelihood or impact of shocks (ex ante) and diminish both the immediate impact on consumption and the longer-term impact on development and growth (ex post)?

The individual case studies underscore the importance of partnership—partnerships between individual least developed countries and international organizations as well as partnerships within a country that include Government, civil society and the private sector. The framework for partnership has been well developed in the Programme of Action for the Least Developed Countries for the Decade 2001-2010 (United Nations, 2001b) and the subsequent progress reports on its implementation.

The Programme of Action also identified factors that contribute to economic growth and development for the least developed countries, and a recent study by IMF economists lends support to the belief that these same factors correlate with periods of growth accelerations in African countries (International Monetary Fund, 2005a; Pattillo, Gupta and Carey, 2005). Countries that experienced growth accelerations came from all income levels and include least developed countries with relatively high levels of economic vulnerability. Not surprisingly, growth episodes are correlated with broad measures of good policy as calculated by the World Bank's Country Policy and Institutional Assessment. Rapidly growing countries were more open to trade, and both increases in investment and total factor productivity appear to be correlated with sustained growth. Perhaps more noteworthy is the importance of competitive real exchange rates and democratic institutions, both of which have been illustrated by the experiences of Botswana and Cape Verde. In another study by IMF staff, Rajan and Subramanian (2005) warn that ODA can be counterproductive because it contributes to overvaluation of the real exchange rate. They find that remittances show no evidence of undermining competitiveness, most likely because the flow of remittances is deterred by an overvalued exchange rate (if the home country currency is too strong, workers will send remittances in the form of goods rather than currency). The challenge, then, is to maintain a competitive real exchange rate. Botswana moved quickly to lower inflows of aid once it had sufficient earnings from exports, and Cape Verde is eager to replace ODA with earnings from service exports.

These experiences highlight the importance of developing a fair and open trade system and a strong, but flexible, financial sector. It is hoped that improvements in regulation and management of banks and capital markets can help individual countries and the world financial system avoid the financial shocks of the 1980s and 1990s. The multilateral development banks are now focusing on financial sector development and financial management in the public sector as important prerequisites for economic growth. The African Development Bank in particular has a programme to develop local capital markets in African countries (African Development Bank Group, 2005, p. 14). If the ability of least developed countries to mobilize domestic resources is enhanced and flows of ODA are stable and manageable, these countries can increase their capability to avoid shocks and to maintain their growth potential, notwithstanding any shocks that do occur.

Nevertheless, a stable real exchange rate, predictable financial flows and the macroeconomic stability related thereto appear to comprise only one aspect of an effective policy response. The ability to craft a successful response appears to depend on education, but not simply on the set of skills associated with higher levels of production. For Mauritius, Botswana and Cape Verde, educational attainment included the development of the capacity to govern and make decisions that have an impact on future development.

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