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**Special Body on Least Developed, Landlocked Developing
and Pacific Island Developing Countries: key challenges
and prospects for Asia-Pacific countries with special needs****Summary of the Asia-Pacific countries with special needs
development report****Note by the secretariat*****Summary*

The present note provides a review of the status, challenges and prospects of Asia-Pacific countries with special needs, together with targeted policy options to promote their inclusive growth and sustainable development. Key areas of economic policy include the macroeconomic performance of these countries in recent years, growth prospects and the structure of the economy in terms of various production sectors, employment shares and final demand.

The note provides a snapshot of the progress made by the countries with special needs according to selected economic and social indicators, and analyses the various structural and long-term development challenges faced by them, highlighting their differences from other developing countries in the Asia-Pacific region.

The note also analyses the role of economic diversification in reducing the vulnerability of these countries, through reducing export concentration, creating jobs, raising gross domestic product and securing competitive advantages within product niches. It identifies policy options in promoting potential new sectors, products and markets for successful diversification of Asia-Pacific countries with special needs, enabling the development of new capabilities and easing their structural bottlenecks.

The Special Body on Least Developed, Landlocked Developing and Pacific Island Developing Countries may wish to review the challenges and prospects of the region's countries with special needs and provide further guidance to the secretariat in its future work in assisting these countries.

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** The present note has been submitted late owing to the delay in finalizing the final draft of the *Asia-Pacific Countries with Special Needs Development Report 2015*.

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I. Introduction

1. Countries with special needs (CSN), comprised of least developed countries, landlocked developing countries and small island developing States, are a heterogeneous group of countries and economies.¹ They vary in economic sizes and stages of socioeconomic development. The group comprises less populous economies, such as Niue (population 1,000), Nauru and Tuvalu (10,000 each), and those with larger populations, such as

¹ This note is based on the *Asia-Pacific Countries with Special Needs Report 2015*. All data, numerical information, figures, tables, estimates and projections are from that report.

Bangladesh (158 million), Myanmar (53 million), Afghanistan (31 million), Uzbekistan (29 million) and Nepal (28 million). Most of the least developed countries have lower income per capita — below \$3,000 in terms of purchasing power parity (PPP) — while Kazakhstan (\$22,467), Azerbaijan (\$16,594), Palau (\$14,612), the Maldives (\$11,283) and Armenia (\$7,527) have higher incomes.

2. Despite those differences, Asia-Pacific CSN share common developmental challenges. Significant poverty continues to persist in many of these countries, especially the Asia-Pacific least developed countries. In addition to income poverty, hunger, food insecurity and malnutrition among children are prevalent. Gender inequality prevails in several dimensions notwithstanding impressive improvements. Large sections of populations, especially in rural areas, continue to suffer from lack of access to safe drinking water and sanitation.

3. Alongside these well-known legacy problems, new challenges too are emerging, such as rising income and non-income inequality, the incidence of non-communicable diseases, unplanned urbanization, growing stress on the environment through rising air and water pollution, inadequacies in waste management, growing scarcity of freshwater and the effects of climate change, with a potentially catastrophic impact on people living in diverse geographies — high mountains, plains, coastal areas and remote islands.

II. Key characteristics and development challenges

A. Geography and demography

4. Geography plays a key role in the socioeconomic development of Asia-Pacific CSN, of which 12 are landlocked and 21 are small island States. Geographical remoteness makes connectivity with the rest of the world an overriding impediment to their socioeconomic progress. Not surprisingly, trade costs are higher for many of these economies.

5. Access to seaports is perhaps the most important constraint faced by the landlocked developing countries. For the majority of them, the nearest seaport is several hundred kilometres away in a neighbouring country. Equally important is the quality of the infrastructure in the neighbouring country. Data on the percentage of roads in a country that are paved show that the Asia-Pacific least developed countries are lacking in good quality roads within their borders, whereas most of the Asia-Pacific landlocked developing countries are much better placed in this regard.

6. For island States, connectivity with the rest of the world is also problematic as they are geographically located far from major economic centres/trade routes. Distance increases transportation costs and trade/economic activity tends to bypass such countries. Only three countries among the Asia-Pacific CSN are littoral, namely Bangladesh, Cambodia and Myanmar. For these three Asia-Pacific least developed countries, geography does not impose a constraint on developing connectivity with the rest of the world for accelerating socioeconomic development. Indeed, in recent times all three countries have seen a spurt in economic activity and investment, including foreign direct investment (FDI), especially in infrastructure.

7. The population growth rate has steadily declined in Asia-Pacific CSN. Current population projections suggest that by 2020 the annual growth rate in Asia-Pacific CSN as a whole would average 1.4 per cent compared with 1.2 per cent for Asia-Pacific developing countries, except China and India.

Population projections suggest that there will be greater pressure on the environment in these countries in the foreseeable future. The population growth rate in Asia-Pacific CSN would decline to just 0.4 per cent in least developed countries, 0.6 per cent in landlocked developing countries and 1.1 per cent in small island developing States by 2050. Life expectancy at birth has also steadily improved in all Asia-Pacific CSN, and there has been a dramatic reduction in variation across these countries over time. Currently, it varies from 61 years in Afghanistan to 79 years in Guam.

B. Persistent poverty, vulnerability and inadequate availability of productive jobs

8. Much of the poverty in Asia-Pacific CSN is concentrated in the least developed countries. In general, poverty rates in the Asian landlocked developing countries (excluding the least developed countries among them) are quite low, less than 10 per cent, and that too on a low population base. Among the Asia-Pacific small island developing States, data on poverty are available only for Fiji, the Maldives and the Federated States of Micronesia. Of these three, only the latter has a high percentage of poverty. Despite the significant progress achieved in reducing extreme poverty, a substantial number of people in Asia-Pacific CSN continue to live under dire conditions, with an income of less than \$1.25 (PPP) a day.

9. Strikingly, between the 1990s and the latest year for which data are available, the annual rate of decline in the poverty rate is higher for extreme poverty (less than \$1.25 (PPP) a day) than when the poverty benchmark is raised to \$2 (PPP) a day. This suggests that the number of poor people who are just barely above the extreme poverty line remains quite high if \$2 (PPP) a day is taken as the poverty benchmark. In other words, the nature of poverty appears to not be changing in these countries even as extreme poverty levels are declining.

10. A major reason for persistent poverty and vulnerability in many of these countries is that economic growth has not generated adequate productive employment. This is seen clearly in the fact that a significant number of those with employment are extremely poor. The problem is particularly acute in the Asia-Pacific least developed countries, which account for the bulk of extreme poverty among Asia-Pacific CSN.

C. High inequality

11. The growth experience of Asia and the Pacific in general since the 1990s has shown that income inequality, as measured by the Gini index, has risen in several countries even as extreme poverty levels declined rapidly. The available estimates of the Gini index for the Asia-Pacific CSN show that this is true only in a few countries, notably Bangladesh, the Lao People's Democratic Republic and Mongolia. Considering that Bangladesh alone accounted for about 41 per cent of the total population in the Asia-Pacific CSN in 2013, the rise in income inequality in this country is a matter of concern.² In most other countries for which comparable data are available, income inequality has declined since the 1990s. Nevertheless, even in those countries the level of the Gini index is fairly high, suggesting that income inequality is an issue that needs to be addressed. Alongside such inequality in income is the non-income inequality in the social dimensions in these

² The Lao People's Democratic Republic and Mongolia accounted for only about 1.8 and 0.7 per cent, respectively, of the Asia-Pacific CSN population in 2013.

countries. These relate to the levels of consumption of food, educational attainment, health status, use of safe drinking water and sanitation, and decent housing. Low levels in these dimensions often reflect problems of access to food and other services.

D. Health outcomes

12. Health is an area where the performance of Asia-Pacific CSN has been poor. These countries have not made much progress in bringing down the rates of infant, under-5 and maternal mortality. Most of them will probably fail to achieve the Millennium Development Goal targets for those indicators. Their poor performance is also evident in the prevalence of diseases, such as HIV infection, malaria and tuberculosis. The occurrence of malaria is particularly high in island States, such as Papua New Guinea, the Solomon Islands and Vanuatu. Even as these countries struggle to cope with communicable diseases, there is a growing incidence of non-communicable diseases, such as cardiovascular conditions, cancer, chronic respiratory maladies and diabetes. In Pacific least developed countries, communicable diseases are a major reason for premature death compared with non-communicable diseases.

13. Overall health expenditure as a percentage of gross domestic product (GDP) shows large variance across the Asia-Pacific CSN — ranging from 1.8 per cent in Myanmar to 15.6 per cent in the Marshall Islands in 2012. Much of the health expenditure, however, is private expenditure in most of these countries. Government health expenditure per capita is quite low in most of the Asia-Pacific CSN. In 12 of the 31 Asia-Pacific CSN for which data are available for 2011, the public health expenditure per capita is less than \$100 (PPP), dropping to just \$4 in Myanmar and \$8 in Afghanistan. In 17 other countries, it varies between \$100 and \$500. Only two economies, Niue and Palau, reported an amount exceeding \$1,000. The number of physicians, nursing personnel and hospital beds per 10,000 persons is quite low in the Asia-Pacific CSN.

E. Access to water and sanitation

14. Safe drinking water and sanitation facilities are essential for a healthy life. In 2012, in only 5 of the 36 economies considered as Asia-Pacific CSN — Armenia, American Samoa, the Cook Islands, French Polynesia and Guam — do 100 per cent of the population have access to safe water. In only 3 of the 12 Asia-Pacific least developed countries (Bhutan, Tuvalu and Vanuatu) and 2 of the 8 Asia-Pacific landlocked developing countries (Armenia and Kazakhstan) do more than 90 per cent of the population have access to safe water. In contrast, in 14 of the Asia-Pacific small island developing States, more than 90 per cent of the population has access to safe water. The situation is acute in Afghanistan where only 64 per cent of the population has access to safe water, followed by Kiribati (67 per cent) and Cambodia (69 per cent). By and large, this is indeed a major problem mainly in the Asia-Pacific least developed countries. In almost all the countries where less than 100 per cent of the population has access to safe water, the problem is relatively more severe in rural areas than in urban areas.

F. Gender inequality

15. Asia-Pacific CSN have made impressive progress in fostering gender parity in education, having already achieved, or are on target to achieve, the targets of the Millennium Development Goals. Gender parity at the school level has the potential of bringing about a positive social transformation over

time, when today's children become tomorrow's adults free of gender bias. Such a bright possibility, however, is at risk if today's gender biases persist and adequate efforts are not made to correct them.

G. Energy

16. The availability and use of energy are not only critical for all forms of modern economic activity but they also play a crucial role in determining the quality of human life in general. Data on energy-related variables are not available for any Asia-Pacific small island developing States and for many of the least developed countries. Total primary energy supply per capita is significantly lower in the Asia-Pacific least developed countries for which data are available than in Asia-Pacific landlocked developing countries, with the exception of Tajikistan. This is not surprising considering that many of the Asia-Pacific landlocked developing countries have rich petroleum deposits and are net exporters of crude oil and/or natural gas. An exception is Myanmar, which has low total primary energy supply even though it is a net exporter of energy. At the other end of the spectrum are Armenia, Cambodia, Kyrgyzstan and Tajikistan, for which at least a third or more of the total energy supply comes from imports. The volatility in the price of oil in global markets means that both the net exporting and net importing countries are exposed to enormous energy price shocks, albeit in different ways.

H. Information and communications technology connectivity

17. Internet penetration in Asia-Pacific CSN shows wide variations across these economies. Internet users per 100 people range from as low as 5.9 in Afghanistan to as high as 66 in New Caledonia. By and large, Internet penetration is higher in many of the Asian landlocked developing countries and small island developing States than in least developed countries, although there are several exceptions in the former two groups.

I. Sustainable urbanization

18. Urbanization in Asia-Pacific CSN has generally been slower than in the Asia-Pacific developing countries. In Asia-Pacific CSN as a whole, only one in three persons lived in urban areas as of 2014, while every second person did so in the Asia-Pacific developing countries, excluding China and India. Current projections suggest that urbanization will continue; by 2050, about half the population in Asia-Pacific CSN is expected to live in urban areas, while it is likely to be close to two thirds of the population for the Asia-Pacific developing countries, excluding China and India.

J. Climate change, environmental stress and natural disasters

19. In addition to the above-mentioned challenges faced by urban centres globally, in more recent times climate change poses new challenges in the form of flooding due to climate events and sea-level rise. Natural disasters are also becoming more frequent with significant losses of life and property. Many urban centres in the Asia-Pacific region, particularly in several least developed countries and small island developing States, are vulnerable to such risks. These vulnerabilities affect the urban poor disproportionately more as they tend to live in the more vulnerable parts of cities; another factor is their low economic base.

III. Economic performance and prospects ahead

20. Asia-Pacific CSN have experienced relatively fast growth in the past decade, but in general that was not accompanied by significant change in the structure of these economies. In terms of employment in particular, agriculture still accounts for a large share of jobs. Most Asia-Pacific CSN have a narrow production base and remain highly reliant on exports of a few commodities as well as the influx of external resources, particularly official development assistance (ODA) and remittances.

A. Size of the economy and growth performance

21. The size of the economies of individual Asia-Pacific CSN vary substantially. Bangladesh is the largest (\$100 billion in 2012) of these economies, while Tuvalu is the smallest (\$26 million in 2012). Indeed, as may be expected, most of the Asia-Pacific small island developing States are the smaller economies among the Asia-Pacific CSN.

22. Real per capita GDP (in constant 2005 United States dollars), however, shows a completely different picture, reflecting the large variation in the population size across Asia-Pacific CSN. All Asia-Pacific small island developing States have a real per capita GDP exceeding \$1,000, and are considered as middle-income countries, according to the World Bank's country classification criteria. In contrast, the non-island States among the Asia-Pacific least developed countries (except Bhutan) and Kyrgyzstan, Tajikistan and Uzbekistan among the Asian landlocked developing countries have a per capita GDP of less than \$1,000, and are considered as low-income countries under the World Bank's classification system. At the aggregate level, the population-weighted per capita income in Asia-Pacific CSN as a whole was just \$1,017 in 2012, which is only 30 per cent of that in the Asia-Pacific developing countries, excluding China and India (\$3,418 in 2012). This clearly shows that the Asia-Pacific least developed countries have a very long way to go to catch up with the income levels of other developing countries of the region.

23. The growth performance of Asia-Pacific CSN, however, compares much more favourably. Between 2003 and 2012, Asia-Pacific CSN grew at 7.3 per cent, 1.5 times faster than the Asia-Pacific developing countries, excluding China and India, and 1.7 times faster during the post-2008 global crisis period.

B. Sectoral composition of gross domestic product and employment

24. Asia-Pacific CSN have experienced relatively fast growth in the past decade, but in general that was not accompanied by a significant change in the structure of these economies. In terms of employment in particular, agriculture still accounts for a large share of jobs. In all but 5 of the 36 Asia-Pacific CSN, the services sector is the dominant sector of the economy. In the five other countries, namely Bhutan and Timor-Leste (among the Asia-Pacific least developed countries), Azerbaijan and Turkmenistan (among Asian landlocked developing countries) and Papua New Guinea (among Asia-Pacific small island developing States), industry is the dominant sector of the economy. Indeed, Timor-Leste appears to be an extreme case since more than four fifths of the economy is in the industrial sector, more specifically mining.

25. Agriculture is the second largest sector of the economy in the Asia-Pacific least developed countries, with the exceptions of Bangladesh (industry) and Bhutan and Timor-Leste (services). In Bangladesh and Bhutan, agriculture was the second largest sector until recently.

26. In contrast, in the Asia-Pacific landlocked developing countries, industry is the second largest sector; the exceptions are Azerbaijan and Turkmenistan (where services comprise the second largest sector). Indeed, agriculture is the smallest of the three sectors in all the Asia-Pacific landlocked developing countries. This is also the case in most of the Asia-Pacific small island developing States, except the Federated States of Micronesia, the Marshall Islands and Papua New Guinea, where agriculture is the second largest sector.

C. Expenditure composition of gross domestic product

27. The lack of structural transformation results in economies that are not diversified and are characterized by a narrow production base. Under such circumstances, domestic demand for products and services invariably exceeds the domestic capacity to supply them. This is reflected in the large share of final consumption in total GDP. In 29 of the 32 Asia-Pacific CSN for which data are available, well over 50 per cent of GDP is accounted for by final consumption of households, and governmental and non-governmental agencies/institutions. This is the case across all Asia-Pacific small island developing States and most of the least developed countries and landlocked developing countries. The exceptions are Timor-Leste among the Asia-Pacific least developed countries (37 per cent), and Azerbaijan (43.5 per cent) and Turkmenistan (22.8 per cent) among the landlocked developing countries. In fact, in 10 countries, final consumption exceeds those countries' GDP. These are Afghanistan, Kiribati and Tuvalu among the Asia-Pacific least developed countries; Kyrgyzstan and Tajikistan among the Asian landlocked developing countries; and the Federated States of Micronesia, the Marshall Islands, Nauru, Samoa and Tonga among the Asia-Pacific small island developing States.

28. Within final consumption, household consumption is responsible for the dominant part compared with government consumption. Households account for well over half the final consumption in all but two countries, Timor-Leste and Tuvalu. In fact, in five countries, namely Afghanistan, Kiribati, Tajikistan, Nauru and Tonga, household consumption is equal to or exceeds the countries' GDP.

29. In the majority (23 in all) of Asia-Pacific CSN, government consumption accounts for less than a quarter of GDP. This includes nine of the Asia-Pacific least developed countries, all the Asia-Pacific landlocked developing countries and eight of the Asia-Pacific small island developing States. At the other extreme are the Federated States of Micronesia and Tuvalu, wherein their Governments account for three quarters of GDP.

30. With very high rates of final consumption, coupled also in some cases with high investment rates, this situation clearly implies that domestic demand in these countries is very high, sometimes far exceeding what they produce. Such high domestic demand is made possible by incurring a large trade deficit,³ as seen in the negative share of net exports (total exports less total imports) in GDP in 25 economies. In only seven economies is the share

³ It should be noted that exports and imports in the database cover goods and services; thus, trade deficit/net exports are computed as exports less imports.

positive for net exports, namely in Azerbaijan, the Cook Islands, Kazakhstan, the Maldives, Timor-Leste, Turkmenistan and Uzbekistan.

D. Trade

31. The high dependence on foreign supplies to meet domestic demand is also seen in the import penetration ratio, defined as the ratio of imports to domestic demand. This ratio is lowest in Timor-Leste (7.1 per cent) and highest in Cambodia (55.8 per cent); it is well over 20 per cent for most Asia-Pacific CSN.

32. Financing such large imports requires fairly robust export performance, apart from foreign inflows of various types. Of the Asia-Pacific CSN, 20 have reported a fairly high export-to-GDP ratio exceeding 20 per cent. In fact, in 12 countries exports exceed 50 per cent of GDP. Exports, however, are concentrated in a few primary commodities in many Asia-Pacific CSN. For example, the top three exports of Azerbaijan, Kazakhstan, Mongolia, Tajikistan and Turkmenistan are oil and mineral commodities; they account for between 64 and 93 per cent of the total exports.

33. With both exports and imports being large as a percentage of GDP, Asia-Pacific CSN show a very high degree of trade openness — defined as the ratio of total trade (exports plus imports) to GDP. The trade openness measure is often used to assess the degree of integration with the global economy. Of the Asia-Pacific CSN, 18 reported a trade openness measure exceeding 100 per cent, implying that the trade sector in these countries is much larger than the domestic sector.

34. High trade deficits in many of the Asia-Pacific CSN do not automatically imply high current account deficits due to offsetting transfer flows. Of the 28 economies for which data on the current account are available, 20 run a current account deficit. Most of the Asia-Pacific CSN fall under two categories, where either the current account deficit is much smaller than the trade deficit, or the current account is in surplus even though the trade account is in deficit, implying that there is a net inflow into these economies' current accounts.

E. Official development assistance and international financing

35. ODA is an important form of intergovernmental currency transfer in the balance of payments. Potentially, it can play an important role in helping developing countries to meet their socioeconomic development objectives. It can also play a major role in reducing the current account deficit of a country. In as many as 10 of the Asia-Pacific CSN, ODA as a percentage of GDP was less than 5 per cent during the period 2008-2012. In four of them — Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan — ODA was less than 1 per cent of GDP. At the other end of the spectrum, 10 Asia-Pacific small island developing States and economies (including some least developed countries) and Afghanistan received ODA in excess of 10 per cent of their GDP. Tuvalu, at 63 per cent, has the highest dependence on ODA.

36. Private remittances by migrant workers are another form of potentially important current transfer flow that can reduce current account deficits. Remittances are, however, an important source of foreign exchange earnings only in a few of the Asia-Pacific CSN. Armenia, Bangladesh, Kyrgyzstan, Nepal, Samoa, Tajikistan and Tonga are countries where remittances exceeded 10 per cent of GDP during the period 2008-2012.

37. Many of the Asia-Pacific CSN receive FDI, which is a capital account transfer that can help bridge current account deficits. As a percentage of GDP, FDI exceeds 10 per cent in five economies, namely the Marshall Islands, Mongolia, New Caledonia, the Solomon Islands and Turkmenistan, the highest being Mongolia at nearly 31 per cent during the period 2008-2012. In 16 other countries, FDI is in the range of 2 to 10 per cent. At the other end, there have been net outward investments from two economies, namely the Cook Islands (-2.6 per cent) and the Federated States of Micronesia (-0.2 per cent), during this period.

38. In the face of current account deficits that FDI and other private capital flows do not bridge completely, Asia-Pacific CSN have to resort to foreign borrowing. Over the years, the stock of external debt has built up in several Asia-Pacific CSN. Data on net external debt are not available for many of the Asia-Pacific small island developing States, including some of the least developed countries among them. Of the 22 countries for which data are available, 15 of them reported net external debt in excess of 25 per cent of GDP. It is highest in the Lao People's Democratic Republic at 86 per cent, closely followed by Kyrgyzstan at 85 per cent. External debt is also very high in Armenia (61 per cent), Bhutan (62 per cent), Kazakhstan (77 per cent), Papua New Guinea (69 per cent), Samoa (52 per cent) and Tajikistan (51 per cent). The lowest external debt is in Turkmenistan (2.4 per cent of GDP).

IV. Pathways to sustainable development

39. Asia-Pacific CSN are committed to overcoming poverty and underdevelopment, and have made some notable progress in surmounting their structural impediments as they move towards achieving sustainable development.

A. Least developed countries

40. The United Nations established the category of least developed country in 1971 to enable such countries to benefit from special support measures to alleviate the structural handicaps that affect their ability to develop. Since then, the least developed countries have been identified by the Committee for Development Policy through three indicators on: (a) income levels, currently measured by gross national income per capita; (b) social progress, currently measured by the human assets index; and (c) economic structure or vulnerability, currently measured by the economic vulnerability index.

41. Since 1991, the Committee for Development Policy has identified countries that should be added to or removed from the category of least developed countries through triennial reviews of all developing countries. During such reviews, the three indicators for each least developed country are measured against specific graduation thresholds. If a country satisfies at least two of the three criteria for graduation in two consecutive triennial reviews, the Committee would recommend to the Economic and Social Council that the country should be considered for graduation. After endorsement by the Council, the case would be submitted to the General Assembly; graduation would become effective three years after the endorsement of the General Assembly. Since 2005, an exception to the two criteria rule was introduced for cases in which a country's gross national income per capita was more than two times higher than the ordinary threshold.

42. Between 1991 and 2014, only four least developed countries were thus graduated: Botswana in 1994; Cape Verde in 2007; Maldives in 2011; and Samoa in 2014. The Istanbul Programme of Action proposed increasing the number of countries graduating from least developed country status. The purpose was to enable half the least developed countries to meet the criteria for graduation by 2020. In the Asia-Pacific region, there were 13 least developed countries at the time when the Istanbul Programme of Action was adopted. Although the graduation goal in that Programme of Action is global in nature, it is useful to note that six Asia-Pacific least developed countries in addition to Samoa should meet the conditions for graduation by 2020.

43. For the three least developed countries that are not landlocked or small islands, namely Bangladesh, Cambodia and Myanmar, gross national income per capita is below the graduation threshold, but the gap is shrinking fast: between 2010 and 2013, it decreased from 40 to 25 per cent in Bangladesh, from 41 to 31 per cent in Cambodia and from 53 to 14 per cent in Myanmar. The group is performing better in the human assets index criterion, as two of them, Cambodia and Myanmar, have already surpassed the graduation threshold, and Bangladesh is making consistent progress, with its gap dropping from 9 per cent in 2010 to 3 per cent in 2013.

44. These countries have also made impressive progress in terms of the economic vulnerability index criterion: Bangladesh has already met the graduation threshold and Cambodia more than halved its gap from 56 per cent in 2004 to 20 per cent in 2013, mainly due to the reduced instability of exports and shorter distances from major world markets. In 2004, Europe and Asia were the destinations of, respectively, 27 and 24 per cent of Cambodia's exports, while in 2012 these shares were 30 per cent to Europe and 33 per cent to Asia. As for Myanmar, its economic vulnerability index dropped from 8 per cent in 2010 to 5 per cent in 2013.

45. Of the four least developed countries that are also landlocked developing countries, only Bhutan has already met the criterion concerning gross national income per capita, with a figure 83 per cent higher than the regular graduation threshold, which is very close to the "income only" threshold. The gross national income per capita of Afghanistan, the Lao People's Democratic Republic and Nepal are below the threshold, but these countries are consistently reducing the gaps. Between 2010 and 2013, the gap dropped from 62 to 46 per cent in Afghanistan, from 29 to 1 per cent in the Lao People's Democratic Republic and from 59 to 47 per cent in Nepal. As for the human assets index criterion, Bhutan and Nepal have already met the threshold for the 2015 review; the gap in Afghanistan fell from 63 per cent in 2004 to 35 per cent in 2013, and the gap in the Lao People's Democratic Republic fell from 26 to 8 per cent in the same period.

46. With regard to the economic vulnerability index criterion, within this group of countries only Nepal has met it, while the Lao People's Democratic Republic has been making very good progress. The country reduced the share of agriculture, fisheries and forestry in GDP from 43 per cent in 2000 to 27 per cent in 2012, while increasing the participation of other sectors in GDP, such as mining, manufacturing and construction. The export instability of the Lao People's Democratic Republic lessened in the period, and the country also shortened distances to major global markets by substantially increasing the share of its exports to Asia over Europe. In 2000, more than 55 per cent of the exports of the Lao People's Democratic Republic were destined for Europe and 38.5 per cent for Asia. In 2012, these proportions switched to 15 and 81 per cent respectively. Only China, which had

previously been the recipient of 1 per cent of the exports of the Lao People's Democratic Republic, received more than 34 per cent of them in 2012.

47. All of the least developed countries that are also small island developing States — Kiribati, the Solomon Islands, Timor-Leste, Tuvalu and Vanuatu — have met the gross national income per capita criterion for graduation, while four of them — Kiribati, Timor-Leste, Tuvalu and Vanuatu — have also met the thresholds for the “income only” graduation criterion. In addition, four countries — Kiribati, Solomon Islands, Tuvalu and Vanuatu — have met the human assets index criterion. Timor-Leste, which has not reached the human assets index threshold yet, has been making steady progress in recent years, halving the gap from 26 per cent in 2008 to 13 per cent in 2013. However, because Timor-Leste has already met the threshold for the “income only” graduation criterion, this means that the five Asia-Pacific least developed countries that are also small island developing States met the graduation criteria.

48. The greatest challenges for the least developed countries that are also small island developing States is their economic vulnerability index, as none of these countries meet the index's criterion for graduation. Kiribati (83.1) had the highest such index in 2013, 160 per cent above the graduation threshold (set at 32), followed by Timor-Leste (55.3), Tuvalu (55.2), the Solomon Islands (47.4) and Vanuatu (44.6). Such levels of economic vulnerability are higher than for any of the other least developed countries.

B. Landlocked developing countries

49. With regard to the Vienna Programme of Action, agreement was reached on six priorities for action to address the special development needs of the landlocked developing countries, three of which were also included in the Almaty Programme of Action: transit policies; infrastructure development and maintenance; and international trade and trade facilitation. The three new priorities are: regional integration and cooperation; structural economic transformation; and means of implementation.

50. Improved regional connectivity is a precondition for the expansion of trade and the sharing of prosperity. However, establishing the right national infrastructure for international connectivity is a complex and expensive challenge for the Asian landlocked developing countries, a challenge which requires strong political commitment and the involvement of the public and private sectors. As a group, the Asian landlocked developing countries have performed relatively well over the past decade. ESCAP calculations show that 62 per cent of the landlocked developing countries' populations are located within 25 km of ICT infrastructure, compared with 59 per cent for the entire ESCAP region.

51. However, physical infrastructure development is still inadequate and poses a major obstacle for the region's landlocked developing countries to reach their full trade potential. In particular, new investments are needed to improve transport infrastructure and logistics services, especially along international intermodal transport corridors serving landlocked developing countries. Moreover, there is a need to invest in terrestrial cross-border fibre-optic infrastructure to connect such countries as India and Bhutan, or Kazakhstan and Turkmenistan. Such bilateral investments would produce even greater benefits if they are integrated into a regional ICT network, such as the Asia-Pacific information superhighway initiative proposed by ESCAP. Energy is another area in which regional networks can be beneficial. The Asian energy highway proposed by ESCAP is a seamless power grid

expected to cover the whole region to enhance energy security and increase the share of renewables.

52. In addition to the challenges posed by the need to boost infrastructure investment, the dependence of transit countries is a major obstacle to reaching international and regional markets. Landlocked developing countries depend on their neighbours' infrastructure, peace and stability, and administrative practices, as well as on sound cross-border political relations. Thus, the harmonization of legal regimes, the adoption of an integrated approach to trade and transport facilitation, and the elimination of physical and non-physical bottlenecks to transport remain major challenges for landlocked developing countries. Domestic reforms are also necessary. Some landlocked developing countries, such as Armenia and the Lao People's Democratic Republic, implemented extensive legislative reforms for the development of transport systems during the previous five years. These reforms resulted in simplified transport regulatory procedures, increased safety and service quality in freight and passenger transport, reductions of excessive administration costs and an improved business environment.

53. In addition to trade and transport facilitation, according to the Vienna Programme of Action, more efforts are needed to diversify the production and export structure of landlocked developing countries, in particular moving from low-value, high-bulk commodities to high-value, low-bulk commodities. This goal is aligned with the view that development is ultimately a process of economic transformation in which labour shifts from low- to high-productivity activities. However, most landlocked developing countries are highly trade-dependent on the export of a few key commodities, generally with low domestic value added. The question for policymakers is how to foster the emergence of more productive economic activities given the technological level of the current production base, the challenges posed by geographical constraints in linking to the global market and the incentives to move away from diversification, which are created by global demand for their primary commodities.

C. Small island developing States

54. The three global development agendas for the small island development States, namely the Programme of Action for the Sustainable Development of Small Island Developing States (Barbados Programme of Action) of 1994; the Mauritius Strategy for the Further Implementation of the Programme of Action for the Sustainable Development of Small Island Developing States of 2005; and the SIDS Accelerated Modalities of Action (SAMOA) Pathway of 2014 coincide in their focus on sustainable, equitable and resilient development. They emphasize the need for sustainable and green exploitation of coastal and marine resources so that long-term and short-term benefits are balanced. In those instruments, a number of points are advocated: equitable sharing of the gains from economic growth; the fostering of an enabling environment to promote value-added business activities; and undertaking multilateral collaboration to confront mutual challenges.

V. Building productive capacities of Asia-Pacific countries with special needs

55. Building productive capacities is critical for CSN in the Asia-Pacific region to overcome their structural challenges and to benefit from greater integration into regional and global economies, to increase resilience to

shocks, to sustain inclusive and sustainable growth as well as poverty eradication, to achieve structural transformation and to generate full and productive employment for all.

A. Productive capacities in countries with special needs in Asia and the Pacific

56. The Asia-Pacific CSN contribute less than 0.4 per cent of global manufacturing production, 1.1 per cent of merchandise exports, 0.5 per cent of manufactured exports and 0.25 per cent of high-technology exports. Among the Asia-Pacific CSN, the landlocked developing countries have higher productive capacities, followed by the least developed countries. These groups have also shown some progress in the past 10 years in increasing their participation in production and trade. The higher and more recent increase was in the share of high-technology exports of landlocked developing countries, which went from 0.03 to 0.20 per cent between 2005 and 2013, although that increase can be traced back to one single country, Kazakhstan. Also noticeable is the increase in the share of Asia-Pacific least developed countries since 2006, which is mainly due to the emergence of the pharmaceutical industry in Bangladesh. On the other hand, the group of small island developing countries in Asia and the Pacific have contributed only marginally, that is, less than 0.01 per cent to those measures. More worryingly, their participation has been declining steadily over the past two decades.

57. In principle, countries could increase their productive capacities by simply producing more of the same products and services — making more T-shirts and extracting more oil, for example. However, implicit in the goal of increasing productive capacities is the idea of moving up on the technological ladder of production and being able to produce different, more sophisticated goods and services.

58. ESCAP has constructed a productive capacity index combining measures of export diversification.⁴ In using that index for 2013, the productive capacity in Asia-Pacific CSN represents only a few percentage points of the productive capacity of the United States, which has the index of productive capacity set to 100. The Asia-Pacific CSN with the highest levels of productive capacity in decreasing order are Kazakhstan (4.64), Bangladesh (3.55), Nepal (2.52), Cambodia (2.38) and Armenia (1.89).

59. Analysis of the evolution of productive capacities in Asia-Pacific CSN suggests that these countries have made slow progress when compared with the global and regional averages. When compared with CSN in other regions, the Asia-Pacific least developed countries have shown higher productive capacities than their counterparts, while Asia-Pacific landlocked developing countries and small island developing States trailed behind. The biggest difference is between small island developing States in Asia and the Pacific and those from other regions, the former accounting on average for only a quarter of the average productive capacity of the latter.

60. Analysis of the evolution of the three-year average productive capacities of Asia-Pacific CSN in the period between 2006 and 2012 shows that, while the majority of these countries have not moved out of a narrow band of low levels of productive capacity, some countries have shown noticeable progress. Among the Asia-Pacific least developed countries,

⁴ ESCAP, *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2).

productive capacity has increased markedly since 2009, in Cambodia from 1.5 to 2.1 in 2012, in Myanmar from 1.2 to 1.7 and in Bangladesh from 3.0 to 3.6. Nepal has experienced slower but steady progress since 2006, while Afghanistan has, since 2009, lost the gains made in the period between 2006 and 2008. Also noticeable is the increase in productive capacity in Fiji, from 2007 (1.2) to 2011 (2.2). Among the Asian landlocked developing countries, Kazakhstan has made remarkable progress since 2010, increasing its productive capacity from 2.2 to 3.4.

61. In addition to reducing the volatility of economic and export growth, economic diversification has also been associated with higher economic output and the lower average number of competitors in the global market, as suggested by the results of recent empirical literature presented in the following section.

B. Policy recommendations

62. Economic diversification requires the adoption of strategic policies by Asia-Pacific CSN. The implementation of such strategic diversification involves the selective promotion of new economic activities over traditional ones through the use of targeted industrial, infrastructural, trade, investment and private sector development policies. Analysis of empirical evidence can be used in the process of identification of the strategic direction of diversification.

63. Also critical is an environment conducive to private sector activities that allow for an easier transition to a more diversified economy. In this process, it is essential to strengthen national institutions and good governance in order to provide a stable environment for the evolution of the economy, the curbing of cronyism and the promotion of development goals.

64. There is no “one-size-fits-all” set of policies that could address the specific binding constraints that hinder private sector investments in new economic activities in each of the 36 Asia-Pacific CSN. However, some general recommendations are presented in this section to facilitate countries’ efforts to foster diversification by improving the business environment and supporting entrepreneurship and to nudge the private sector towards new economic activities producing more complex products.

65. Overall, the exchange rate plays a critical role in promoting tradables and the emergence of new economic sectors. The main set of policies is meant to neutralize the tendency towards appreciation and to maintain a competitive exchange rate. That strategy is compatible with a floating but managed exchange rate regime. Two basic instruments that are used by many countries, although not openly admitted to, are: (a) maintaining the domestic interest rate at a low level; and (b) buying international reserve currencies. Commodity-dependent countries that face the threat of the so-called Dutch disease could levy tax on exports of the primary commodities that cause the tendency towards appreciation of the currency and the creation of an international fund (sovereign wealth fund) to neutralize the potential re-appreciation of the currency due to the inflow of tax revenue.

66. Other monetary policies also play a supportive role in increasing productive investments in new sectors. Favourable credit conditions for productive sectors and for the promotion of new economic activities in particular are helpful for job creation and diversification. Macroeconomic stability, including moderate and stable inflation, and sustainable domestic and external imbalances also create an environment conducive to private sector investment in diversifying the economy. In this connection, when

facing domestic or external shocks, countries need to consider using the full scope of appropriate countercyclical policies to maintain economic and financial stability and to avoid sudden economic fluctuations.

67. A stable investment-friendly and competitive macroeconomic environment will facilitate economic diversification but will not automatically result in diversification towards the economic sectors that have higher potential for promoting development. To accomplish that, after setting the strategic direction for diversification with the identification of potential new sectors to promote, the Government should establish a process designed to identify areas in which policy actions are most likely to make a difference — a process whereby the Government and the private sector jointly come up with the required supportive policies, incentive structure and institutional arrangement to ensure the flow of private investment in the identified niche.

68. Policies related to infrastructure have to be selective in terms of the economic activities that they will promote. Therefore, infrastructure policies should be focused on directly facilitating tradable production, in agriculture and industry, and in facilitating the shift of the country's product mix towards more complex economic activities. In some Asia-Pacific CSN, development of the basic infrastructure of transport, telecommunications and energy is still required and should be provided before and in support of the more targeted infrastructure projects to promote the sectors selected for strategic diversification.

69. Fiscal policy is an important instrument to promote diversification. Tax incentives for first movers into new targeted sectors stimulate private sector investment. The Government's procurement expenditure can also contribute significantly towards achieving the goal of economic diversification. In many countries, the Government spends substantial amounts on procurement. Government procurement expenses, because of their quantitative importance, have the potential to leverage the private sector towards socially beneficial sectors. By buying from companies that produce new and more complex products, the Government can support their expansion.

70. Asia-Pacific CSN should continuously explore new markets and formulate policies that assist in expanding the participation and increasing technological content in regional and global value chains. In order to diversify markets and products, Asia-Pacific CSN need to explore intra-regional initiatives through regional trade agreements. Regional trade agreements can be an important tool for market diversification as they can be used to promote trade in goods through dismantling tariffs and non-tariff barriers, to attract investments, to promote trade in services and to reduce trade transaction costs through trade facilitation measures. This would also assist in reducing supply side constraints, which will ensure development of regional value chains, and promote intra-regional investment and technology flows.

71. Another way to facilitate strategic diversification is through the attraction of foreign investment while ensuring meaningful linkages and spillovers into the local economy and local enterprises. Multinationals bring in new productive capacities for the country but that does not mean that such productive capacities would naturally spread throughout the economy. They may just stay within the limits of the multinational — with no spillover. If the company that comes into the country requires parts and components that the domestic economy is not able to provide — those that require productive capacities that the country does not have available — the new plant will not create opportunities for diversification. Countries should seek FDI not only for the sake of more investment but also to use FDI to promote diversification of the economy. For any FDI that comes into the country, there should be a

clear strategy on how to use it for domestic production and for promoting further diversification.

72. It is vital for Asia-Pacific CSN to have access to a variety of financial services and products in support of private investment in new economic activities. This requires a diversified, well-regulated and inclusive financial system that promotes savings and channels them into productive investments.

73. The domestic supply of long-term capital also needs to be increased by developing domestic capital markets, venture capital funds, term-lending institutions and industrial development banks. It is important to facilitate the development of domestic finance sources to avoid the tendency towards exchange appreciation due to the inflow of foreign savings. On the revenue side, policies need to be focused on broadening the tax base and introducing direct taxes. In commodity boom countries, that strategy will reduce excessive dependence on resource revenue.

74. There is scope for reform of public finance. For Asia-Pacific CSN, there is substantial scope for domestic resource mobilization. For example, in 2011, on average, the tax-to-GDP ratio in Asia-Pacific least developed countries was only 10.4 per cent of GDP for central government revenues, compared with 17.1 per cent of GDP in Latin America and the Caribbean and 16.3 per cent in sub-Saharan Africa. Subject to broadening of the tax base and strengthening tax administrations to curb tax evasion and avoidance, Asia-Pacific CSN can mobilize additional tax revenues worth between 4 and 5 per cent of GDP.

75. Collectively, there is a need for stepping up global partnerships to support CSN development and for bringing about fresh impetus for advancing implementation of the international action programmes for CSN. In that regard, there is need for action on multiple fronts. On 7 December 2013, the adoption of the so-called Bali Package at the Ninth Ministerial Conference of the World Trade Organization reaffirmed the commitment of its member countries to duty-free, quota-free market access for least developed countries without inducing greater flexibility in its coverage and rules of origin. In addition to advanced countries, the expansion of emerging markets in terms of their duty-free, quota-free schemes would be useful. In moving forward, there is a need to consider promoting simplification and harmonization of rules of origin across all schemes (reciprocal and non-reciprocal preferential rules of origin) that grant preferential access to least developed countries alike. Only with such harmonized rules could least developed country producers have the opportunity to better integrate and participate in global value chains, exploit potential economies of scale, substituting among markets in accordance with changes in demand, and achieve greater stability in earnings.

76. At the same time, regional aid-for-trade initiatives should be focused more on projects covering trade infrastructure and other aid-for-trade projects. In addition, it is desirable to give more attention to aid-for-trade projects demanded by CSN. Technical assistance will help CSN meet the standards and regulatory requirements of developed countries. Current regional trade agreement initiatives, in particular the proposed trans-Pacific partnership, the regional comprehensive economic partnership and the free trade area of the Asia-Pacific region, do not include many countries with special needs. Yet, when such countries are included, there is a lack of special preferential treatment — the Association of Southeast Asian Nations has none, for example.

77. ODA, even though smaller than private foreign flows such as FDI and remittances, has the power to catalyse development. If developed countries are to follow up on their commitments, and there is a focused strategy to strengthen and recalibrate ODA flows to enhance their support for physical and social infrastructure development, the prospects and opportunities made possible by ODA inflows can effectively provide a boost to bridge the resource gap for the development of Asia-Pacific CSN. However, the financing of graduation gaps will mean going beyond ODA. Countries could explore alternative sources of financing by harnessing private investment through an enabling policy environment and appropriate incentives to attract sufficient long-term private investment and remittances, the inflow of which totalled \$23 billion in Asia-Pacific least developed countries in 2013. In addition to recognizing climate finance as an integral part of development finance, adequate fiscal provision for addressing climate adaptation and mitigation will reinforce development.
