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PART I: MIDDLE-INCOME COUNTRIES AND THE AID SYSTEM

Chapter 2. The characteristics of MICs

2.1. The identification of middle-income countries

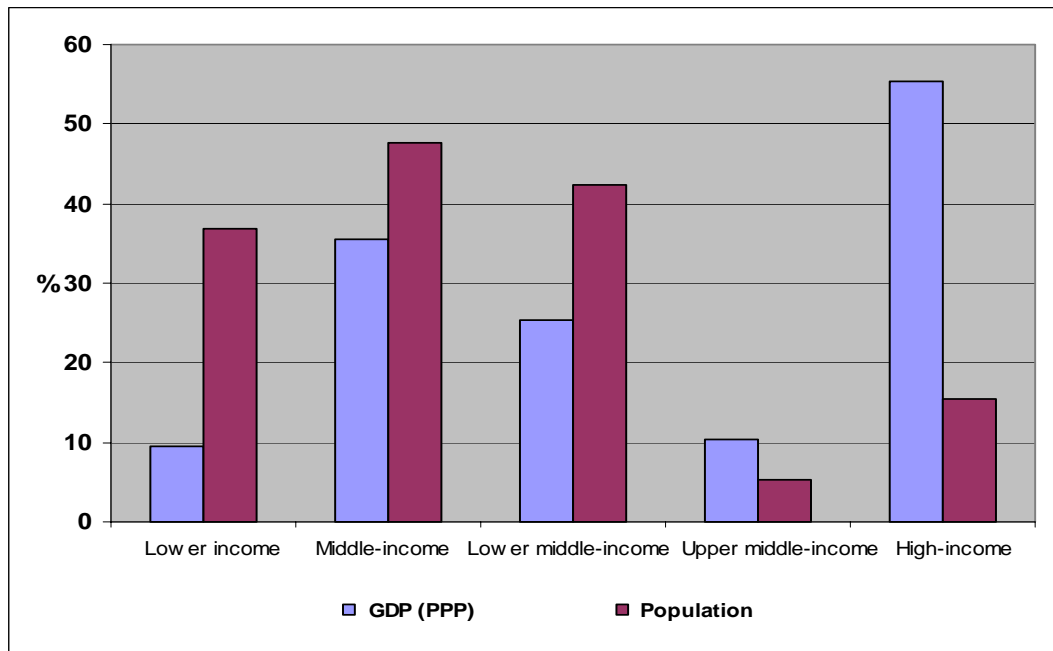
4. According to the benchmark used by the World Bank (2005), the middle-income group comprises 93 countries or territories where per capita income lies between \$766 and \$9,385 (in 2003 dollars). This group is further broken down into two subgroups: lower-middle-income, embracing 56 countries with per capita incomes between \$766 and 1.1yiddle-incwith per -:1

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archipelagos, a factor that poses additional difficulties to them in integrating their domestic markets. At the other extreme, five countries have more than 100 million people and one of them, China, has nearly 1.3 billion. These discrepancies in size pose an additional problem when it comes to preparing common assessments or developing proposals for general application.

7. The MICs account for nearly one-half (47.6%) of the world population; and China alone plays a decisive role, with 19.3% of the world population. Yet the population weighting of the two subgroups is very different: lower-middle-income countries have the greatest demographic burden. With respect to their economic weighting, the MICs account for around 35% of global GDP (at purchasing power parity). Lower-middle-income countries contribute 25 percentage points of this total, and the upper-middle-income countries 10 points (Chart 2).

Chart 2: *World income and population distribution*



Source

Table 1: *Economic and Social Indicators by income group, worldwide*

	Year	Income levels					
		World	Low	Middle	Lower-middle	Upper-middle	High
<i>International weighting of MICs</i>							
Exp+Imp of goods & services	2003	100					

2.2. Characteristics of MICs

9. Despite their obvious differences, the MICs can be characterized by a number of traits (Table 1):

- They are at an advanced point along the demographic transition curve, and now have fertility and population growth rates lower than the world median, and a life expectancy at birth that is slightly higher than the world average. The age structure of the population is midway between that of low-income countries (where the younger strata predominate) and those of high-income countries, with older populations.
- Their technological capacity indicators are very close to the world average, although they still fall short of those in high-income countries. There are moreover notable differences among the countries in the group.
- The intermediate positioning of the MICs is improved when it comes to social variables: their Human Development Index is above the world median. The same holds for the infant mortality rate, the adult literacy rate, and the proportion of the population with access to drinking water.
- The above-mentioned social indicators would be better if these countries exhibited greater equity: as it is, they have high inequality indicators, even greater than those for low-income countries. This high degree of inequality means that poverty rates are above those corresponding to their level of development. In both cases, the average figures conceal highly divergent national situations.
- Finally, the available indicators on institutional quality, even with their inherent shortcomings, indicate that MICs (especially the lower-income ones) fall well short of high-income countries, and the indicators are dispersed widely around the world median.

10. In recent years, MICs have turned in a relatively good economic performance: their average annual growth rate since 1990, at around 3% per capita, has been slightly higher than the world median. This success was largely due to progress in the lower-middle-
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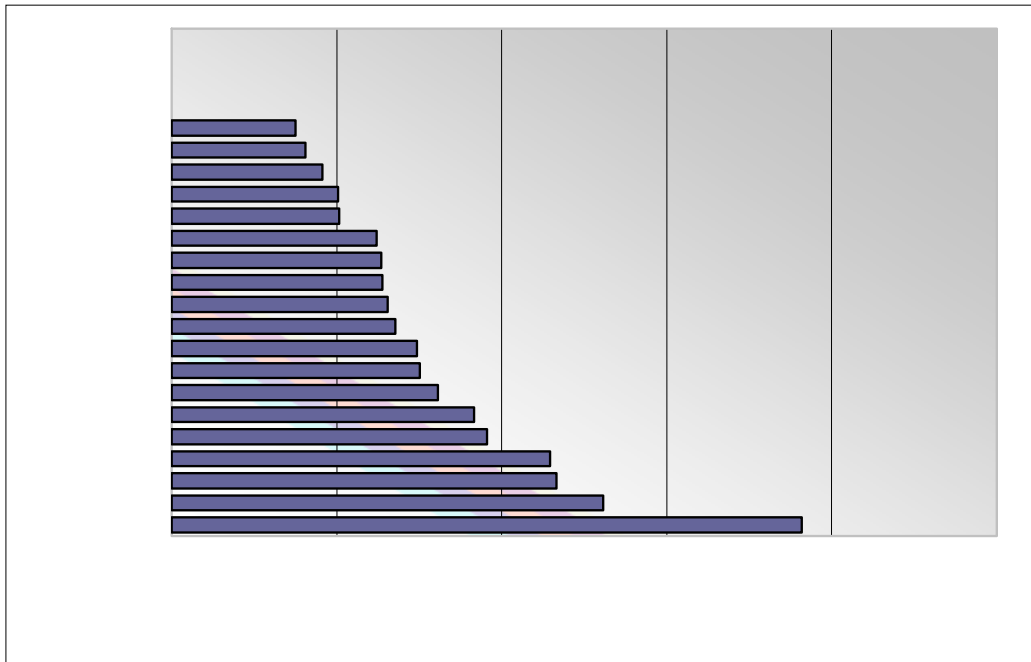
12. The reduction in the relative weight of the MICs can be analyzed more closely by looking at mobility between income strata. If we take the period 1978-2003, only one country has successfully climbed from the low-income to the lower-middle-income level, while a vastly larger group (up to 25 countries) has moved in the opposite direction. In turn, of the lower-middle-income countries that succeeded in raising their status, only one made the double leap to the high-income stratum, and three others achieved upper-middle-income rank. Of the countries in this last group, 13 dropped to lower-middle-income, while 10 rose to upper-income status. Finally, in the case of high-income countries, all but one remained in that category. This analysis offers some interesting conclusions: first, it is the MIC group that demonstrates the greatest mobility; and second, there have been more cases of countries moving down the scale than in the other direction. These conclusions point to the importance of supporting the development achievements of MICs to prevent them from losing ground.

...has followed a slightly upward path over
...1991, funding increased by a factor of
...), and the number of donors also
...both current and constant terms.
...at the beginning of the
...for humanitarian undertakings,
...clear

14. The slow growth of aid stands in contrast to the performance of other international financial flows to developing countries. In 1989, the four main components were roughly similar in magnitude. After that date, private lending followed a very unstable but rising

16. If we look at the distribution of aid over time, we find that there is a certain consistency in the relationship of the principal donors with MICs. In absolute terms, the greatest contributions have come regularly from the United States, Japan, France, Germany, Spain, the Netherlands, and the United Kingdom. In relative terms, Greece is the country that devotes the greatest portion (nearly three-quarters) of its bilateral aid to lower-middle-income countries. Next in importance stand Spain, Austria and Japan, where the LMIC share exceeds 40% (Chart 5). The weighting of upper-middle-income countries in the allocation of bilateral aid is much lower: on average they account for barely 3%. The countries that accord the greatest importance to this group of upper-middle-income countries, with shares exceeding 6%, are France, Austria and Spain.

Chart 5: *Relative share of middle-income countries in total bilateral ODA flows (average 2000/2004)*



18. Nevertheless, it would appear that this effort has sometimes been approached in an excessively simplified way that unduly narrows the comprehensive perspective that aid should have. While it is reasonable to give preference to countries with the greatest levels of poverty, it may also be appropriate to maintain international support for the efforts of countries that have already moved beyond this threshold. Not only will this avoid any backsliding in their social achievements, it will also support their progress and that of their regional setting, and bring more stable governance to the international system. Just as with the middle class in any society, the presence of a broad group of middle-income economies making sustained progress lends stability and dynamism to the international system.

19. The policy of cooperation with MICs must begin with recognizing the heterogeneity of this group: it embraces countries with widely divergent development possibilities, very different sizes, and contrasting economic and social achievements. Consequently, there can be no single diagnosis of them, nor are they susceptible to any attempt at shared therapy. Nonetheless, there are five reasons that justify an active policy of development cooperation with middle-income countries, compatible with the preference that must be given to the poorest countries.

a) Supporting achievements in poverty reduction

Although they are not the countries with the highest levels of poverty, the MICs are home to 13% of the world's people who must live on less than a dollar a day, and 41% of those with less than two dollars a day. In some cases, these poverty levels are the result not so much of low average incomes as of the faulty distribution of income within the country. The chief political responsibility for eradicating poverty therefore lies with national governments themselves, which will have to implement the social policies and redistribution mechanisms required to achieve this objective. Yet international cooperation can help in this task, not only by supporting government efforts with international resources and expertise, but also by establishing the incentives needed to give the battle against poverty its proper place of priority on the public policy agenda.

b) Avoiding backsliding in social and economic achievements

One of the characteristics of middle-income countries is that their growth rates are highly volatile. This points to a second reason for a more active policy of cooperation with middle-income countries: to avoid any backsliding in the progress achieved to date by these countries. In the end, one basic purpose of the international cooperation system should be to consolidate development progress and make it irreversible.

c) Centres of growth in the regional setting

A third reason for international cooperation to engage itself actively with MICs is the weight that some of these countries carry in their regional settings. In much of the developing world, a small number of MICs account for between a third and a half of their region's population and its aggregate output. The stability and health of these economies then becomes a factor for equilibrium and progress in that

setting, acting as an anchor for the subregion. It is reasonable to suggest that international cooperation should take advantage of these externalities through an aid policy that will guarantee maximum impact in inducing progress in that setting.

d) Provision of international public goods

A fourth reason has to do with the crucial c-0.0008 ggesing. oct e has6(MICs play setp of d6(r).72

points to a number of factors that have been recognized as useful for improving the effectiveness of aid:

a) Ownership

The effectiveness of aid depends crucially on its capacity to subordinate itself to the purposes and development strategy of the recipient society. It is important, then, to support a system that will give the recipient a greater sense of ownership over the aid it receives.

b) Stability of aid flows

The unpredictability and variability of aid flows imposes a cost in terms of aid effectiveness, for it impedes programming, disrupts the macroeconomic stability of recipients, and limits the productive use of aid in investment. All of this suggests that aid should be designed as part of a broader programming framework, with commitments that extend well forward in time.

c) Donor coordination

The aid system relies to a great extent on the bilateral action of donors, who frequently fail to coordinate their activities properly. The situation is further complicated by the growing number of multilateral agencies, both official and private, now active in the aid field. To encourage greater coordination among donors is thus a prerequisite for enhancing aid effectiveness, and for reducing the transaction costs of aid.

d) Conditionality

With the intention of limiting recipients' room for discretion in the management of funds, donors have established demanding conditions for the granting of aid. This approach is out of line with the objective of fostering

factors that condition this process have to do with the effects that over-indebtedness has on some financial markets that are highly volatile, in a setting of domestic capital markets that are glaringly shallow. With high ratios of debt to GDP, liabilities denominated in foreign currency and often in short-term securities, countries are hostage to the vagaries of the market. Because of their indebtedness, countries must maintain high primary surpluses, leaving them limited room for independent management of expenditure, and thereby considerably reducing their ability to pursue countercyclical policies. The international financial climate accentuates the pro-cyclical thrust of economic policy in these countries, which is relaxed during boom times when capital is flowing in, and contracts when capital flees the country. This factor has been aggravated as a result of financial liberalization and deregulation on the capital account. To cushion this impact, the regulatory asymmetries of the international financial environment will have to be corrected and countries will have to be given more leeway in designing countercyclical policies, while strengthening their domestic financial markets.

27. The third set of problems reflects countries' difficulties in building technological capacities so that they can encourage change in the composition of their industrial and export production, moving into activities of greater productivity and growth potential. The new regulatory frameworks for international trade and intellectual property have reduced the scope for domestic policies to generate productive capacity and promote dynamic competitive advantages. Under these conditions, some MICs appear content to base their advantages on products that are intensive in natural resource or unskilled labour content, with limited capacity to accu

- Finally, a portion of the benefits that middle-income countries can derive from international cooperation comes from its role in changing the legal and regulatory frameworks that govern international economic relations and in reducing the cost of countries' access to the benefits that the international market offers in the areas of trade, technology and finance.

29. In addition, donor efforts should be designed to involve MICs actively, either individually or through their regional institutions, in the international cooperation effort. This means identifying within the MICs capacities and initiatives that may be useful to the strategy of other developing countries, and promoting mechanisms for the countries involved to exchange experience and to take joint action. This approach can strengthen the feeling of participation and ownership in development initiatives, it can bring those initiatives more closely into line with conditions in the affected countries, and it can produce a "double dividend", whereby both developing countries, the donor and the recipient, can build capacities.

5.3. The Multilateral Development Banks and the MICs

30. According to data available at the end of 2004, the loan portfolio held by the Multilateral Development Banks (MDBs) in the MICs amounted to \$237 billion. The bulk of these resources (almost half, or 45%) was contributed by the International Bank for Reconstruction and Development (IBRD), followed by the Inter-American Development Bank (IDB) with 21%. Despite the relative importance of this official financing, the bulk of financial resources flows to MICs through their direct access to private markets. In fact, in recent years, official financing accounted for not much more than 30% of the financial resources received by middle-income countries, with nearly 70% coming from private financing.

31. The activity of the MDBs can be very important to MICs, for at least three reasons:
- Although MICs may have readier access to capital markets, especially now, not all countries have that possibility to the same degree, nor is it certain that any one country's access will remain unchanged over time. Within the middle-income group there are also countries that have no stable access under acceptable conditions to capital markets.
 - In addition to providing loans, the MDBs can work in other ways, such as with indirect financial instruments (providing guarantees, for example) and non-financial instruments (technical assistance, policy advice, and support for capacity development).
 - The MDBs can help countries pursue their own development agenda, overcoming both the market failures and the government shortcomings that limit this possibility.

32. As a country moves forward in the development process, it is reasonable to assume that its demands on the MDBs will shift to new forms of financing and to other kinds of activities relating to strategic services and know-how. On this latter point, the MDBs can help to bridge the gap between the increasingly strict domestic and international demands

for good governance and the constraints that a country's limited institutional and technical capacities may impose. Technical assistance, policy advice, and institutional strengthening measures constitute important fields of work. Equally important are the tasks of designing national development strategies or administering regional or global initiatives for the provision of public goods that will produce a dual benefit, at once local and global.

33. This process can also involve the MDBs in developing new financial services for the MICs, including:

- Tools for mitigating the risks of external disruptions, such as those associated with currency or interest rate fluctuations, volatile prices for basic products, and natural disasters.
- Instruments for financing subnational public institutions.
- Instruments for financing the private sector with more stable conditions and at an acceptable cost, while being careful not to have the MDBs replace private capital. This activity is especially important in new areas of private investment such as infrastructure.
- Finally, developing financial instruments in the domestic currencies of MICs in order to avoid currency mismatches in their debt.

34. The MDBs need to try to correct those factors that now limit access to their financing. These relate in particular to: (i) excessive demands in terms of conditionality; (ii) the resource costs (such as administrative costs and credit and commitment fees) involved in preparing projects and following the procedures required to access financing of this type; and (iii) the inadequate adaptation of institutions of this kind to the characteristics, management procedures and specific needs of each country. These criticisms, of course, do not apply in equal measure to all MDBs. But at the same time, there is a need for more effective coordination among MDBs and a clearer definition of their respective comparative advantages so as to foster a healthy division of labour internationally.

35. The MDBs should also continue to operate as co-financing institutions, blending bilateral and multilateral aid, in areas that are of high priority for a country's development strategy, as in the case of infrastructure. They should also become involved in operations that attract private financing, through cooperation with commercial financial institutions. In this way, the MDBs could fulfill more adequately their function as investment catalysts, while contributing an appropriate combination of technical know-how and social sensitivity. Beyond their activity in individual countries, the MDBs should understand that their responsibility also extends to the regional level, where they can strengthen regional integration efforts and support the provision of international public goods.

5.4. South-South cooperation

36. While development assistance was traditionally characterized by a North-South axis, the late 1970s saw the emergence of South-South cooperation, the main feature of which has been to establish cooperative links among developing countries. This should not be

seen as an alternative to North-South cooperation, but rather as a complementary strategy. With its horizontal structure, South-South cooperation is better positioned to generate a sense of ownership on the part of the recipient, to sponsor initiatives more in tune with the conditions and needs of the countries affected, and to promote activities that will generate a "double dividend" by stimulating the technical and institutional capacities of both the donor and the recipient. There are three areas in particular where this kind of cooperation has been successful: (i) the macroeconomic front; (ii) finance for development; and (iii) technical cooperation.

Union, of course, has an important third mechanism as well, in the form of regional transfers for redistribution purposes, but there are no similar experiments in developing countries, perhaps because of shortcomings in their fiscal systems. The best-tested experiments in this field are the development banks that developing countries have established. Although such institutions are to be found in all regions of the world, the most complete network is that serving the Arab and Islamic countries (Islamic Development Bank, Arab Fund for Economic and Social Development, Arab Monetary Fund, Arab Bank for Economic Development in Africa, etc.) and in Latin America and the Caribbean (Andean Development Corporation, Central American Bank for Economic Integration, and Caribbean Development Bank). More recently, the Asia-Pacific region has seen initiatives designed to create infrastructure in support of national or regional bond markets, and the issuance of regional bonds.

40. The development of South-South cooperation mechanisms for development finance produces benefits of three kinds: (i) it gives countries a greater sense of “belonging” to institutions, and keeps those institutions more closely attuned to the conditions of the countries involved; (ii) it makes services more accessible to small and medium-sized countries; and (iii) it makes it possible to coordinate and finance goods with significant regional externalities, such as infrastructure, a mutual trading system, or the exchange of experience. These institutions also suffer some limitations: their ability to grant concessional loans is constrained if their membership is restricted to developing countries, which suggests the need for complementary financing mechanisms that will involve donors in financing for the poorest countries. But even if industrial countries do not participate, financial institutions can play an important role as a mechanism for providing finance, guarantees and risk management. One example can be seen in the Andean Development Corporation, which has achieved an “investment-grade” rating that none of its individual member countries enjoys.

c) Technical cooperation

41. Within South-South technical cooperation that will

45. This set of factors highlights the importa

50. Reducing corruption is one of the priorities for the proper performance of a market economy. While the degree of corruption and the measures to combat it are highly case-specific, one approach is to create an environment that minimizes the possibility of committing illegal acts, such as by simplifying regulations. Transparency is another way to combat corruption. Yet it is important to have in place systems to enforce the law against illegal behaviour: otherwise, greater transparency and public awareness of corrupt practices may simply foster a perception of impunity.

51. While each country must shoulder the responsibility for its own institutional change, international cooperation can support this process in two fundamental ways. First, through dissemination and exchange of potentially replicable experiments, thus reducing the costs of innovation, provided that the specific nature of each experiment is recognized. Second, through efforts at social strengthening and the empowerment of social groups that will cooperate in institutional change and bring pressure to make institutions more inclusive and responsible.

6.2. Economic growth, inequality and poverty

52. The evidence suggests that there is no single, universal relationship between economic growth and social equity. Simila

needed to avoid a worsening of the situation of families at times of crisis. Ideally, their design should combine short-term income maintenance with structural measures to combat poverty, especially those intended to enhance the educational assets of low-income families. Experience also shows how complicated it is to develop such safety nets during a crisis, and suggests that they should be created before a crisis strikes.

56. The need to articulate redistribution policies is forcing MICs to increase social spending significantly. The potential redistribution effect of this option is limited, however, by three contrasting circumstances:

- A portion of social expenditure is regressive (or only minimally progressive), which requires us to consider not only its dimension but also its distributive impact.
- Tax systems do not always have the capacity to finance a desired increase in expenditure. The need to increase tax revenues is greater in those countries with less-developed contributory protection systems, a common feature in countries where the informal sector is significant.
- Contributory protection systems have limited coverage, which means that non-contributory protection must be expanded. Such expansion must be designed to avoid sharp differentiation between contributory and non-contributory systems.

57. There are a number of possible strategies for avoiding budgetary constraints to increased social expenditure. On one hand, it would seem essential to strengthen the universal elements of social protection, in particular those with the greatest potential impact on economic growth over the long term. In any case, it is important to eliminate the regressive features of such policies and to make substantial improvements to the quality of basic services such as health and education. This should be compatible with a last-resort social safety net that is targeted at the poorest households by selection. The main advantages of targeting are to contain costs and to reduce the most severe forms of poverty, recognizing that in this case there is a need for information to identify the beneficiaries.

58. One important innovation in this field is to make transfers to poor families subject to specific conditions, such as school attendance and the use of basic health services, two key factors for short-circuiting the intergenerational transmission of poverty. In some countries these programmes have gone beyond

59. A significant aspect is the optimal distribution of responsibilities among the different levels of government involved in combating poverty. In principle, government decentralization should have a positive impact on poverty, although there is not sufficient evidence to confirm this. In the case of MICs, decentralization must not be allowed to undermine the response capacity of income support systems in situations of crisis, which suggests the need for compensation mechanisms managed by central governments.

60. From the viewpoint of international cooperation, action should follow two tracks. In the first place, the provision of basic health and education services should be made less regressive, and their quality should be improved. In the second place, social safety nets should be reinforced, taking into account the advantages and limitations of targeting and of conditional transfers. In addition, financial and technical assistance should be provided to support the adoption of best international practices.

6.3. Fiscal possibilities

61. Taxation is a crucial aspect in the development process, for it affects the economic behaviour of individuals, determines the public sector's capacity for action, and constitutes the social contract on which the concept of citizenship rests. An appropriate taxation system, then, is a prerequisite for countries to progress. Yet designing a tax system that reflects the basic criteria of sufficiency, efficiency, equity, administrative simplicity and flexibility poses some problems in the case of MICs.

62. In fact, the tax systems of MICs differ from those of developed countries both in quantitative terms and in the weighting of the various types of tax. On the first point, public revenues as a proportion of GDP averaged nearly 43% in developed countries in 2000, but only 28% in middle-income countries, and 23% in low-income countries. These gaps reflect in large part the disparities in tax revenues, which amount to 38% of GDP in high-income countries, 25% in middle-income countries, and 19% in low-income countries (Table 3). Besides these quantitative differences, there are also contrasts in the structure of tax revenues compared with high-income countries. In the MICs:

- Taxes on goods and services are relatively more important, and their weighting has increased as a result of tax reforms over the past decade.
- Social security contributions account for a lower portion of revenues.
- Taxes on international trade are relatively more important, although their weight is declining.
- Income taxes account for a much lower share, with a bias in favour of corporate taxation, which is easier to collect.

Table 3: *Taxation by level of national income (year 2000)*

manage. At the same time, in many developing countries there are important sectors, such as services or retail trade, which are not subject to the VAT. Agriculture constitutes a special case, where transactions often escape control by the tax administration.

66. The importance of taxes on international trade has declined sharply in developing countries in recent years, largely because of more liberal trade policies in those countries. However, replacing customs duties with the VAT requires strengthening the tax administration to avoid losses in revenue collection capacity.

67. Empirical studies on the impact of tax reforms show that the results are mixed. There are five basic reasons for these findings:

- Many tax reforms followed a "standard" scheme in replicating tax systems in the developed world, without taking into account the developing countries' limitations or their particular features.
- Tax reforms have been geared to increasing revenues and achieving greater

- Finally, pay greater attention to institutional and distributive aspects that condition the effectiveness of reforms, not only in terms of collection and efficiency but also in terms of the social legitimacy of tax systems.

69. International cooperation has a role to play in tax reform, in at least three areas. First, it can help in the design and technical development of reforms, drawing not only upon experience in developed countries but also upon approaches taken in other MICs. Second, it can assist in the technical and institutional strengthening of tax administration by improving statistics, training staff, and enhancing the institution's operations. Although nearly all developing countries have

not have the same capacity or continuity of access to international capital markets, and this in turn has implications on their ability to pursue independent economic policies. In the case of MICs, the combination of volatile capital markets and high rates of indebtedness reinforces the cyclical behaviour of their economies. Maintaining high interest rates makes these emerging markets attractive, and at times of growth they record strong inflows of capital, which tend to drive up the exchange rate. The high level of indebtedness and the short maturity of their debt instruments impose continuous debt rollovers, and this makes these countries extremely vulnerable to any domestic event (a decline in growth rates or a political crisis, for example) or external shock (an adverse shift in the terms of trade, or contagion from a financial crisis). In the case of such a shock, the appreciation of the currency can quickly turn into a rout, imposing even higher interest rates and dampening the prospects for growth. During a crisis, multilateral debt (channelled by the IMF) will gradually replace private capital as it flees the country. If the stabilization effort is successful, the currency will stop depreciating and opportunities will emerge for beginning a new cycle; but if stabilization fails, the country will be plunged into a financial crisis, the length and severity of which will depend on the case.

73. This behaviour of financial markets tends to determine and amplify swings in the national economic policy cycle. In boom times, markets encourage expansionary policies that foster recourse to international financing, while at times of downturn governments must tighten up their responses to save their reputation on financial markets. At these times, the indebtedness ratio usually deteriorates, and this demands an even tighter fiscal policy. On the contrary, during an expansion, fears of a debt crisis will fade and governments will tend to increase their spending. This behaviour exacts a high cost and impacts the country's investment and growth prospects. Hence the importance of giving these countries some room for manoeuvre in designing and implementing countercyclical macroeconomic policies.

74. One important element to this end is the system adopted to manage the exchange rate. Anxious to offer assurances to demanding international markets against intervention by the economic authorities, many MICs have resorted either to a fully flexible (floating) exchange rate, or to pegging their currency to some international reserve currency. Neither of these options is free of criticism. It might in fact be reasonable for MICs to adopt exchange rate regimes somewhere between those extremes, by setting a specific target for the real exchange rate as part of the economic policy framework. In any case, there is no one exchange system that will suit all countries.

75. Fiscal policy is a second field for action towards macroeconomic stability. Yet the scope of action in this area is conditioned by budgetary constraints, given the low level of public revenues and the prevailing inertia of expenditure. Moreover, international instability accentuates the pro-cyclical sign of this policy, which suggests the possibility of designing flexible taxes on some specific revenue sources to dampen its impact. Despite such difficulties, a degree of fiscal policy autonomy vis-à-vis the cycle can be achieved through a tough economic policy stance. One example is to set medium-term fiscal targets (for the deficit or for the maximum rate of public sector indebtedness) that will over time offer the flexibility needed to run a countercyclical policy. In addition, thought could be given to creating stabilization funds that will help temporarily to

sterilize surplus public sector revenues deriving, for example, from spikes in export prices or in other fields of public revenue. A proper system of social protection can have a similar effect, as demonstrated in the stabilizing role that social security plays in many developed countries. Establishing such systems would not only have a countercyclical impact but would also help to reduce the social gap in many MICs.

76. Finally, a significant consideration for a country's autonomy of action is the capacity it reserves to itself to impose regulations on capital transactions. Although the effectiveness of such measures is not guaranteed, maintaining some regulation over the capital account can help give greater effect to a contractionary monetary policy in times of market euphoria, and avoid the costs inherent in an excessive build-up of reserves. At the same time it allows economic agents to restructure their debt towards longer

78. Because of its weight in the MICs, the efficiency and competitiveness of the banking system is crucial in determining the borrowing costs of economic agents. Recent years have seen efforts to advance toward this objective via the privatization route. As in other fields, evidence shows that, however desirable privatization may be, it must be done in ways that avoid the establishment of uncompetitive market structures or of practices that accentuate rather than correct the levels of aggregate risk. The process of financial liberalization has also been pursued as a way to stimulate savings, reduce constraints on capital accumulation, and enhance the efficiency of resource allocation. Again in this case there are some possible objections to an excessively doctrinaire implementation of this recommendation, recognizing that reforms have sometimes had the undesired effect of reducing credit to certain sectors, such as small and medium-sized enterprises, which suggests that in some cases selective intervention may be appropriate.

79. One of the main financial problems facing MICs is the absence of a domestic market for long-term private and public bonds. This makes it difficult to finance certain kinds of investment, such as infrastructure, and leads to currency mismatching in the debt structure of some economic agents. Promoting the development of such markets may also require some public stimulus as backing for the activity of market creators (such as insurance and pension funds). The development of these collective savings institutions can also be important for giving depth and efficiency to capital markets and for promoting financial innovation through the rollout of new intermediation and risk diversification products. Regulation of this important market segment is thus an important aspect for the development of financial markets in the MICs.

80. If a country is to develop its financial system, it has to provide its people with access to formal banking services. In this field again there are deficiencies associated with the low levels of banking penetration in many MICs.

83. One area of the international financial system in which the greatest progress has been made in recent years has been the adoption of better mechanisms for prudential regulation and supervision over financial systems in developing countries. The objective

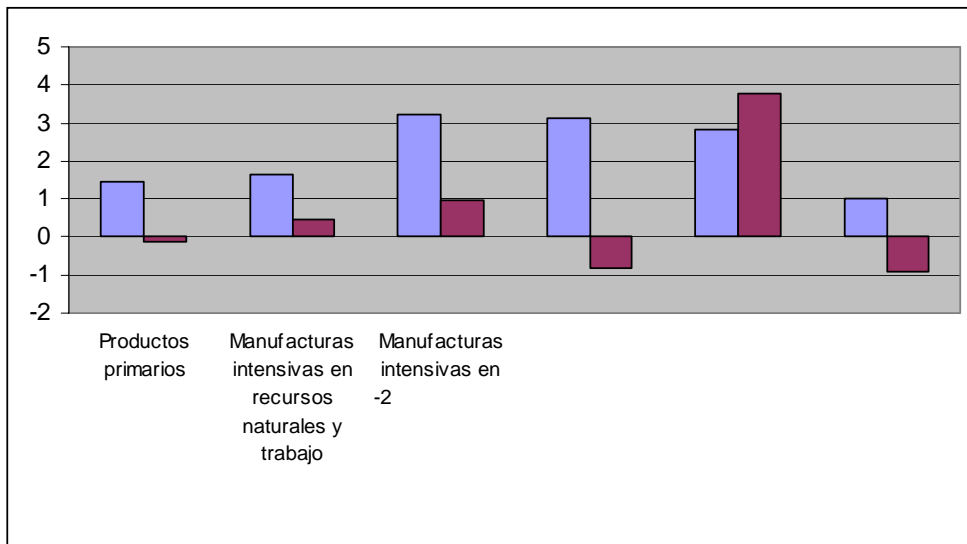
creditors and debtors. Proposals in this direction have received support from the G-10 and from the IMF. The use of collective action clauses has in fact spread rapidly, and in 2005 they were applied to nearly half of bonds issued. Despite their widespread use, it is still too early to judge whether this more decentralized (and market-oriented) route will produce the desired effects over the medium a

8.1. *International trade*

89. Over the last 15 years the MICs have made great efforts to open their economies to the outside world, and have made the conquest of international markets one of the key factors for promoting their progress. As a result, they have cut their levels of tariff protection, they have increased the share of international trade in their GDP, and they have fostered a climate of greater competition on their domestic markets. In addition, the MICs have expanded their share of world trade: they now account for 23% of total exports of goods and services, of which more than half (12.6 percentage points) originates from lower-middle-income countries and the remainder (10.4) from the upper-middle-income group. The bulk of this share corresponds to trade in goods, while services account for a much smaller portion. Moreover, a comparison of their fields of specialization shows that MIC exports are concentrated in products associated with their natural resource endowment (such as mining, agriculture and fuels) rather than in manufactures and services.

90. Within the manufacturing sector, MICs tend to specialize for export in activities that rely intensively on unskilled labor and natural resource processing, while developed countries are more heavily into technology-intensive industries and product differentiation. Consequently, while the MIC share of trade in manufactures has grown significantly (to 19% of total exports), there are still notable differences in the content of their respective specializations. Those differences have implications in terms of economic and technological dynamism, because the productive profile conditions the capacity to promote technical change, to generate value-added, and to create dynamic advantages (chart 7).

Chart 7: *Per capita growth of developing countries (105 countries) according to their pattern of specialization*



91. In addition to their export makeup, the MICs display some other features that require attention:

- Their "trade intensity" is still low: exports per capita amount to barely 10% of the level in high-income countries.
- As a result of their specialization in raw materials, some MICs (i) face high volatility in prices for their exports and (ii) are missing out on opportunities to accumulate technological capacities that will generate dynamic advantages for their areas of specialization.
- Their export patterns are concentrated in two ways: (i) by markets: at least 29 countries ship more than 50% of their exports to a single market; and (ii) by products: for 46% of upper-middle-income countries and 37% of lower-middle-income countries, the weighting of their first three export products exceeds 50% of their total exports.
- Finally, the concentration of exports and the instability of their average prices mean that revenues from international sales fluctuate sharply, and this has sparked concern to find effective compensatory schemes.

92. The characteristics of MICs' trade reveal two very important areas of potential enhancement. First, there is broad scope for improving all those non-price aspects of external competitiveness that have to do with the capacity to differentiate products, either through superior technology or through more active international marketing. A second issue has to do with consolidating the productive transformation process and moving into more dynamic areas of specialization, with a higher technological content and greater value-added. Progress on these fronts is constrained not only by domestic capacities but also by the restrictions that the international system of trade regulation may impose.

93. Of the 82 MICs for which the necessary data are available, 67 are members of the World Trade Organization (WTO), 14 have observer status and are at various stages in the accession process, and only one has no relationship with the WTO. All of this indicates that the international trade of MICs is subject, more or less directly, to multilateral rules. With the exception of the 10 transition countries of Eastern Europe, the remaining 71 benefit in addition from the advantages that fall to developing countries in multilateral negotiations. This should encourage MICs to participate actively in negotiations within the WTO forum. Specifically, it would seem reasonable for them to insist that the body of

which combine high tariffs with anomalous systems of output and export subsidies. The support mechanisms of various kinds that developed countries grant their farm exports (subsidies, export credits, government trading enterprises, food aid and countercyclical payments, among others) are incompatible with the objective of open and competitive trade. In August 2005, the European Union offered a gradual build-down of its export subsidies, and this laid the basis for the agreement adopted in Hong Kong, setting the year 2013 as the date for the final elimination of farm export support measures. That agreement must await the outcome of the Doha Round. Besides export support, several major developed countries maintain agricultural production subsidies that affect market competition. The Doha Round should also put an end to such distorting measures.

95. MICs are increasingly becoming party to one or more regional integration schemes, while remaining WTO members, and these arrangements may constitute an effective way for strengthening their export capacities. However, experience in the EU shows that such arrangements must be based on a pragmatic process for the continuous reduction of barriers to intraregional trade, and a shared willingness to cede areas of sovereignty in favour of collective decision-making and policy harmonization.

96. Within the great variety of economies in the middle-income group there are some, especially among the lower-middle-income ranks, that lack the technical means to play an active and advantageous role in international trade negotiations. International cooperation can offer technical assistance to help offset this disadvantage. Cooperation can also serve to support the design of institutions and policies for promoting competitiveness and helping firms to "internationalize", building on the experience of developed countries and other MICs. Finally, another useful area for international cooperation is to address the effects of volatile raw material prices by supporting export revenue stabilization schemes.

97. Over the long term, the best guarantee for improving the trade performance of MICs is to transform their output and trade into products that offer higher and more stable growth and make greater use of technology. Once again, the situations will differ from country to country. But we can identify some areas where assistance would be of great interest. For countries with lesser capacity, normally the smaller countries, many of them island nations, technical cooperation can be a good start for identifying sectors for future development as well as enhancing the potential of existing sectors. Yet many MICs already have the strengths and capacity to complement cooperation, which could focus above all on reinforcing the fundamentals for change and specialization, through investment in infrastructure, human resources and technological capabilities.

8.2. Developing technological capabilities

98. It is the pace at which technological capabilities can be accumulated that conditions an economy's growth performance and its ability to compete on international markets. Hence the importance of laying a national basis for the sustained accumulation of technological capabilities. When it comes to developing countries, such accumulation generally involves not radical innovations that push the frontiers of knowledge, but rather

Table 4: *Technology indicators*

	R&D spending (% GDP)	R&D spending (per capita)	R&D researchers (per 1,000,000 inhabitants)	Patents (per 100,000 inhabitants)	Publications (per 100,000 inhabitants)	High-tech exports (%Expor.Manuf)
Low-income countries	0.37	7.02	233.98	0.49	0.62	4.86
Middle-income countries (1)	0.49	35.01	964.68	2.20	5.74	9.41
Middle-income countries (2)	0.39	25.10	631.54	1.05	3.77	9.77
Lower-middle income	0.44	19.83	933.20	2.56	3.14	8.54
Upper-middle income	0.55	49.86	1004.04	1.77	9.42	10.62
Transition	0.75	63.85	1746.38	6.99	11.98	7.34
EU15	1.79	523.28	2906.83	40.93	59.51	20.27
Japan	2.99	795.42	5104.22	306.52	43.68	28.35
United States	2.72	921.87	4.525.8	62.21	69.53	33.52
Total	0.98	89.48	1497.81	14.52	21.55	10.83

Source: Prepared by the author from World Bank data (WDI, 2005).

Note: the figures for lower-middle-income and upper-middle-income countries include the transition countries. The average values for “middle-income countries (1)” include transition countries; “middle-income countries (2)” is the average excluding transition countries.

101. The development of digital technologies has defined a new technical and economic paradigm that includes a set of basic technologies that condition economic activity and innovation processes. Yet access to ICTs is uneven, and they must therefore be seen as one more factor of international inequality. The MICs present a highly varied picture in their access to ICTs: the upper-middle-income countries perform above the world average in the number of mobile telephone subscribers, telephone lines, and Internet users. Yet for the more sophisticated dimensions, such as Internet nodes and the number of computers, their indicators are below the world average. The lower-middle-income countries lag further behind, particularly in those aspects that reflect higher qualifications, such as Internet access or the number of computers.

102. The above data show the need to devote greater efforts to developing technological capacities in the MICs. This is a process that seems to be associated with the pace of human capital formation, on one hand, and with processes of capital accumulation and productive change, on the other. The first requires strengthening the levels of individual education, from a comprehensive perspective that considers the quality of higher education and its relevance to the labour market. The second process will rely on the mobilization of domestic resources, efficient import substitution, and the active international marketing of products.

103. The international transfer of knowledge is a mechanism that has allowed many economies to overcome their domestic limitations. Through technical assistance, donors can transmit their technological expertise in fields essential for development such as food technology, biotechnology, renewable energy, or health and education technologies. Bearing in mind the success that some MICs have had in developing their capacities, greater emphasis should also be given to horizontal cooperation in technology among MICs themselves, with donor support.

104. One field that is ripe for such action is scientific cooperation, through joint training and research programmes, the exchange of researchers, and networking between research teams and centres. To make this possible, universities and research centres will need to take a more active role in defining the fields of cooperation, leaving it to government to support individual mobility and strengthen institutional networks. Technical cooperation is another area of activity in which there is experience (as in the EUREKA case) based on technological cooperation between businesses and research centres. Some specific activities can be based on new partnerships between businesses, universities and research centres at the international level, with government support. The technologically more advanced MICs also offer opportunities for technology transfer in which both parties to the transaction can benefit.

105. Technology development strategies have often relied on external factors for promoting technical change. In some countries, foreign investment has played a key role in high-tech manufacturing. For this reason, improving MICs' ability to attract foreign investment may be considered one way to bolster technological capabilities, provided that foreign investment is soundly rooted in the local productive fabric. Experience shows that such attractiveness is conditioned by, among other factors, the presence of an appropriate regulatory framework, a skilled labour force, and adequate infrastructure (both conventional facilities and the ones that provide know

109. In addition to the shortage of facilities, there are other problems relating to infrastructure management, including:

- Inadequate, over-dimensioned, or poorly conceived infrastructure, for which maintenance is often abandoned, and which therefore represents investments of doubtful social return.
- Defective operation of infrastructure, whether for technical or economic reasons, which means that the return on investment is again limited.
- Lack of financial criteria in taking investment decisions and in providing services, leading to excessive and non-recoverable expenses.
- Failure to address the specific needs of the poorest population groups and the most vulnerable communities.
- Failure to consider environmental problems, with the result that significant negative impacts are not properly evaluated.

The mere listing of these problems suggests that the quality of infrastructure is another important factor, in addition to securing the necessary financing.

110. Many public utility services were traditionally provided by government-owned enterprises. While public institutions must retain ultimate responsibility for the provision of such services, recent years have seen a shift in the way infrastructure is managed, involving a greater role for private initiative. Among the factors encouraging this shift are: (i) technological advances, which have dissolved the natural monopoly inherent in some activities; (ii) the fragmentation of production into various segments, some of which can be opened to competition; (iii) financial constraints on government's ability to invest and to secure a return on investment; and (iv) the problems that public enterprises face in managing services efficiently. All of these factors have induced a search for new forms of partnership with the private sector, involving outright privatization as well as private participation in financing new facilities. This changed landscape opens the way to new sources for the provision of infrastructure, which will require structural and regulatory reforms that will make markets attractive to private financing. This is a step that MICs will have to take in order to draw full advantage from the market's potential for developing infrastructure.

111. The changes indicated have been accompanied by new contractual forms and the allocation of ownership rights over infrastructure. The options run the full range from full private ownership to absolute public ownership, using all kinds of contractual arrangements, including service contracts, management contracts, and various combinations such as Build, Operate and Transfer (BOT). If these new arrangements are to work properly, there must be an appropriate regulatory framework that will protect the investor from arbitrary government intervention while at the same time protecting users against the dominance or monopoly of private operators. This demands, in the first place, a properly designed concession contract, a sound regulatory framework, and an accurate definition of contractual conditions; and in the second place, the conditions for enforcing contracts.

112. Infrastructure construction generally constitutes an opportunity for expanding capital markets and broadening the portfolio of projects for domestic and foreign

investors. Given the constraints facing developing countries, an infrastructure investment programme can create opportunities for expanding and deepening capital markets. On this point, developing countries need to take steps to make these markets function properly, to strengthen the financial system, and to support the efforts of institutional investors such as pension funds and insurance companies.