



Commonwealth Policy Studies Unit: 23

**2007 Commonwealth Finance Ministers' Meeting:
Policy Brief**

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Executive Summary

2006 was a good year for world growth but a bad year for development. Despite the promises of 2005, international aid budgets now look increasingly imperilled while deals on debt relief are only delivering limited gains for those fortunate enough to have acquired post-MDRI status. For those still in the process of gaining meaningful concessions from the IFIs it is increasingly like getting blood out of a stone, in part leading to increases in non-concessional loans from commercial creditors. If we turn to trade the picture doesn't improve: the Doha Round is increasingly devoid of any development content with vested political interests still trumping the demands of exporters, but this is not merely a north-south battle, developing countries are increasingly fearful of major emerging markets working against their interests - finding a common position is thus critical.

The major challenge for the Commonwealth in 2007, while politically unfashionable, is to get the MDGs back on track; it is the MDGs that should steer aid flows, the MDGs that should set debt sustainability frameworks and the MDGs that should orchestrate trade negotiations. The fact we passed the MDG mid-point without the international community blinking at the lack of progress made is cause for concern, as should the abandonment of targets to reduce the global prevalence of HIV/AIDS. The Commonwealth is still well placed to push the boundaries of international development in the right directions with innovative thoughts for the IFIs and practical solutions on the ground - particularly through encouraging poor countries to take an assertive lead when shaping their own development agendas. Addressing climate change, while crucial, will need to be weaved into development agendas rather than competing with them for increasingly sparse funding, not least as solutions remain the primary responsibility of the developed world.

Executive Summary

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1 Status, representation, recent meetings

The Commonwealth provides an expansive intergovernmental framework for ministerial forums ranging from Heads of Government to Education ministers. Together with the CHOGM and HIPC forums, the annual meetings of the Commonwealth Finance Ministers' provide a crucial platform to push for pro-poor development and harness globalisation to good effect. The CFMM meetings command a near 100% attendance record of member states; the last two ministerials in Barbados and Sri Lanka provide no exception to this rule.

The Commonwealth draws together 53 states of disparate character, including wealthy industrialised members of the G8 - to 14 of the UN defined 'Least Developed Countries' of the world and 25 of Small Island Developing States. It is also home to a number of burgeoning developing countries in the G20 that continue to grow in political and economic stature alongside G6 powers and the NAMA-11 states, many of whom provide the latest constellation of powers that can progress what remains of world trade talks.

This years CFMM deliberations will take place in Guyana on 16-17th October and is hosted by the Hon Dr. Ashni Singh, Minister of Finance of Guyana. The Commonwealth HIPC Ministerial Forum, the Commonwealth Central Bank Governors Meeting and Senior Finance Officials meetings will all take place on the 15th October. As with previous years, the Commonwealth has scheduled its meetings to take immediately prior to the IMF/World Bank meetings on 20-22nd October to ensure its voice is heard in a timely manner and key messages carried forward to the World Bank Development Committee and the International Monetary and Financial Committee. The Commonwealth will certainly look to influence the World Bank's proposal on debt and macroeconomic management in low income countries; apply pressure to ensure ambitious IDA 15 replenishments and lobby the IFIs to do more to support global public goods while making greater provisions for fragile states.

Commonwealth Finance ministers have much to reflect upon from the last time they met, particularly as international development has in places slipped down the global agenda. Aid flows look increasingly uncertain while developing world debt is re-accruing as quickly as it was 'cancelled' in 2005. The Doha round remains stymied in desperate need of political capital to avoid forsaking the considerable development gains that could be made on agriculture, NAMA and services. Reaching consensus on 'reciprocity' will be important, but the concerns of LDCs need to be placed back at centre stage as trade negotiating committees reconvene in September to offer the 'trappings' of a development round beyond 'Aid for Trade'. This will require concessions by developed and emerging economies alike, particularly as many developing countries fear that exports from large markets such as China will swamp their domestic markets foreclosing future avenues of economic diversification.

Civil society groups will be able to make their voice heard via a 'stand alone' statement and through the Commonwealth Foundation in Guyana on the Special Theme examining climate change and development. The Commonwealth Business Council will also provide critical business perspectives on this debate which has been a 'hot topic' of international discussion this year; most controversially when the British Government tried to discuss the linkages between climate change and conflict in the UN Security Council in April. The Guyana meetings fall neatly between UN

deliberations in September and the Bali meetings in December designed to formulate a follow-on Kyoto agreement. But the fact the US has already signalled its intention to parallel talks in the AP6 suggests that whatever successor agreement is put in place for Kyoto, it is likely to be grossly inadequate to offset the worst effects of climate change. The Commonwealth has been active on climate change in the past - particularly in relation to Small States - but as a recent UN report highlighted, \$200bn a year will be needed to return to today's levels of emissions by 2030 through R&D investment in renewables and efficiency measures before we even consider the policy costs involved in longer term mitigation measures.

2 Record for Policy

The Commonwealth represents a quarter of the world's governments, one third of the world's population and accounts for a fifth of global trade. It encompasses members of the G6 and G8, to key players in the G20, G24, G77, G90 and G110. It also possesses the advanced economies of the OECD and some of the emerging 'Asian giants' yet at the same time is home to fourteen of the world's Least Developed Countries and twenty-five of the forty-six Small Island Developing States. Not surprisingly, the Commonwealth has a major stake in the HIPC initiative, with many of the 40 (actual or potential HIPC's) coming under Commonwealth affiliation. Within this breadth of membership, the Commonwealth has rightly focused its efforts on development issues and the fact that southern voices can carry equal weight with their industrial and post-industrial counterparts adds a dialectical quality to the Commonwealth that few organisations can match.

Mauritius (1997) and Ottawa (1998) focused in on the urgent need for fundamental reform of the regulation of international flows in the wake of the Asian currency crisis in order to stop the balance of risks reaching critical levels in future. Ironically, the 'excess' foreign reserves now held in emerging markets to guard against external shocks represent a new set of problems; understandably, developing countries are reluctant to adjust their portfolios through fears of precipitating a fall in the dollar and inflicting capital losses upon themselves but at a policy level, such reserves carry the potential of creating inconsistencies between the effects of interventions in the currency markets and monetary policy creating fiscal costs. It also raises questions about the sustainability of net outward transfers.

Reform of the IFIs to bring developing countries into decision making process has been a repeated theme of CFMM meetings, particularly in Malta (2000) which is starting to be answered by the IMF and World Bank who resolved to 'reflect important changes in the weight and role of countries in the world economy'. Last years meetings in Singapore increased the quotas for a number of countries (notably China, Mexico, South Korea and Turkey) and raised the number of basic votes cast by each country to enhance the voice of developing countries. But further reform is still needed, particularly to enhance Africa's voting share above the current 5.6% and updating the composition of the Executive Board which still reserves 9 of the 24 seats for European countries. While the use of a quota formula method has gained ground this should be pegged to purchasing power parity and shift away from 'financial openness' that favours developed countries. Trebling (not doubling) low income countries basic votes should also form the basis of reform.

Having provided the intellectual stock for the HIPC initiative in the 1980s and acted as a key advocate for change since (including the Enhanced HIPC Initiative in 1999), the Commonwealth has called on the Bretton Woods Institutions to ensure that the debt sustainability framework is aligned to achievement of the MDGs and to give urgent attention to relieving the debt burden of other poor countries excluded from the HIPC process. In this respect, the Gleneagles G8 meetings was a notable success in establishing the Multilateral Debt Relief Initiative, but it will need to go further to be effective while getting to grips with commercial creditors as concerns of unsustainable debt resurface.

London (2002) Brunei (2003), St Nevis & Kitts (2004) and Barbados (2005) maintained momentum on the primary issues of debt, aid and trade whilst reflecting on promoting investment, fighting the HIV/AIDS pandemic and promoting trade liberalisation for development purposes. They also highlighted the chronic need for increased international aid budgets to meet UN targets of 0.7% GNI by 2015. But as seen at this years G8 meetings, a number of states were even cautious of repeating the 2005 Gleneagles target of increasing development assistance by \$50bn by 2010.

According to the World Bank overall flows of aid and debt relief to Africa dropped in 2006 to \$35.1bn from \$38.5bn; under current commitments, aid will only reach 0.36% of GNI by 2010, which is well below commitments made in the Monterrey Consensus and the estimated \$150bn increase needed per year to reach to MDGs according to the UN Millennium Project Review. A key theme of this years meeting will be to ensure that whatever aid is delivered is done so in an effective and targeted manner in keeping with absorptive capacities under a new *Action Plan* designed to work towards the 2005 Paris Declaration on Aid Effectiveness. The fact that states such as Brazil, China and India are now both major recipients *and* donors of development assistance underlines the need for greater coordination as we now have too many players with inadequate rules. Better monitoring of aid flows, national ownership, harmonisation, and mutual accountability would clearly be a good starting point.

The Commonwealth remains the leading advocate for the cause of small states of fewer than 1.5m people throughout the international system. Such states lead a precarious economic and social existence, and are most critically vulnerable to the vagaries of international economics and shocks. This trend is exacerbated for states with 'endowed handicaps', which further stack the odds against long-term growth and poverty reduction. The joint Commonwealth-World Bank task force report delivered last year "*Small States: Meeting the Challenges in the Global Economy*" laid a firm policy agenda to reduce the vulnerabilities of Small States, but the focus now must be one of effective implementation within the Commonwealth and throughout the IFIs and regional development banks. When addressing small states issues, the Commonwealth has been actively engaged on the OECDs 'harmful tax practices initiative', but Commonwealth reports in 2006 revealed that the cost of regulatory initiatives are having a significant net negative impact on Commonwealth International Financial Centres without providing much benefit. Although the OECD Global Forum on Taxation is a positive initiative in this respect, reform must be implemented on a level playing field and not as *pick and chose* option for the US and EU to gain relative advantages in financial services for investors.

The Commonwealth has also repeatedly sought to give genuine ownership of PRSPs to developing countries, and to ensure that they are tailored towards realising the MDGs from a donor and recipient perspective. This was the overriding theme of the Barbados (2005) meetings in progressing the *Commonwealth Action Plan on Delivering the Monterrey Consensus* (2002) and will be revisited this year by analysing PRSPs in Bangladesh, Malawi, Tanzania and Ghana respectively. Recognition of the value of heterodox development policies (Sri Lanka 2006) took a further step in this direction but ‘take-up’ of such policies the IFIs remains limited.

Last years meetings pre-empted many of the concerns that have played out in 2007 including calling for movement in the Doha Round beyond ‘Aid for Trade’ to benefit LDCs while pressing for multilateral efforts to offer some form of exit route from growing imbalances. Progressing debt relief through the MDRI and ESF and amending sunset clauses was also high on the agenda scoring limited policy success (at least with IMF and African Development Bank rather than IDA). The Commonwealth has reiterated its bid to promote investment into high risk markets over a number of years, yet progress on this front has been decidedly sticky and could get even stickier as markets look to greater certainty in light of increased volatility and illiquidity.

3 Agenda for 2007

The current draft agenda, which will be confirmed or amended on the eve of the conference, is as follows:

3.1 Election of Chairperson

3.2 Adoption of Agenda

3.3 Current World Economic Situation and Prospects

An examination of the world economic situation and prospects for 2007/8 and inherent dangers including:

- Prospects for the world economy and economic performance of developing and transitional economies such as India and China
- Risks associated with high and volatile oil prices and likely associated inflationary pressures
- Prospects for a sharper-than-expected slowdown of the US economy, a widening of the US current account imbalance, a depreciation of the US dollar; and disorderly adjustments of global imbalances.
- A possible rise in protectionism and the foregone growth should the Doha Round fail to be concluded by the end of this year
- The ability of poor and vulnerable countries to take advantage of the Aid for Trade Initiative and increased (but still insufficient) Official Development Assistance
- Items relevant to the agenda of the Development Committee and the International Monetary and Financial Committee
- Progress on issues arising from the Commonwealth HIPC Ministerial Forum (CHMF) following meetings in Washington DC (April 2007) including ongoing concerns regarding the Multilateral Debt Relief Initiative (MDRI) the low participation of non-Paris Club bilateral and commercial creditors in

providing debt relief, the free rider problem, the need to expedite the eligibility for countries with significant arrears as well as the World Bank's proposal for a global partnership to strengthen debt and macroeconomic management in low income countries.

- Discussion of solutions to the debt problems of highly indebted small states
- Debate around donor and international financial institution support for country-owned poverty reduction strategies with a formal review of Bangladesh, Malawi, Tanzania and Ghana highlighting common difficulties and lessons learnt

3.4 Special Theme: Climate Change: The Challenges Facing Finance Ministers

- Discussion of the potential impact on growth and development of climate change, with particular reference to those from the poorest and most vulnerable states
- Discussion of policies and instruments needed to address climate change and the development challenges it poses
- Input from the civil society/Commonwealth Foundation
- Business perspective from the Commonwealth Business Council

3.5 Small States Issues

- A review of the progress made implementing the recommendations made to the ComSec/World Bank Task Force Report on "Small States: Meeting the Challenges in the Global Economy" at least years CFMM in Sri Lanka

3.6 Commonwealth Development Co-operation

- A review of the CDC to provide an assessment of the Secretariat's work on investment, public financial management reform and gender responsive budgeting
- Discussion of reform of the international aid architecture through consideration of an Action Plan put forward by a Task Force regarding the Commonwealth's role in this area following last years meetings

4 Comments on numbered agenda items

3.3 Current World Economic Situation and Prospects

The global economy has seen steady growth over recent years and expanded by 5.5% in 2006 with advanced economies growing by 3.1%, and emerging and developing economies by 8.1%. Among other things, this has been underpinned by the rapid growth in the volume of world trade, which grew by 10.2% in 2006; expanding capital flows to developing countries (\$647bn) and strengthened external positions for emerging market economies. Asian economies have seen the strongest growth led by China at 11.1% through ongoing investment and sustained export growth. India's expansion continued its momentum with growth over 9% but is expected to ease fractionally into 2008 amid inflationary pressures and continued monetary tightening. Growth in Latin America also fared well in 2006 at 5.5% thanks to Brazil, Mexico and Argentina where consumption and investment were stronger than expected. Growth in the Newly Industrialised Asian Economies held firm at 5.3%, but will be difficult to sustain into 2008.

Growth in Europe and Japan was stronger than widely forecast in 2006, but still failing to hit 3%. The new accession states to the EU have maintained momentum in 2006 through strong domestic demand and ongoing FDI supporting robust consumption. The CIS have registered strong if uneven growth of 7.5% in 2006 due to firm oil and non-oil commodity prices¹ which has been mirrored in the Middle East and in parts of Africa - although disparities between oil exporting and importing countries remains significant.

The snag is that this 'good news story' was predicated on benign conditions in 2006 of lower oil prices and positive global financial conditions helping to contain the initial correction in the US housing market and keeping inflationary pressures in check. But the latest meltdown in sub-prime mortgage markets in the US and subsequent 'revelation' of a credit crunch has increased the probability of a longer and more pronounced decline as the effects work their way through overextended markets.² In the drive for greater yield, markets have taken on increased risk but this has been channelled through poorly understood markets and instruments, suggesting the implications of a major correction will hold dire consequences for emerging markets heavily dependent on capital flows. In such an analysis, a disorderly adjustment of global imbalances, high oil prices, creeping inflationary pressures and unpredictable shocks start to look more menacing.

Although optimists claim that a weakening US dollar and greater flexibility in some surplus economies reduces the short term risk of a disorderly unwinding of imbalances, the long term outlook remains bleak.³ The combined Asian currency reserves have doubled since 2003 to \$2,500bn. The Gulf States now have combined foreign reserves of almost \$1,600bn, even greater than China's \$1,100bn. With corresponding large deficits in the West, (most notably the US), economists are seriously questioning how long accumulation of foreign liabilities can remain sustainable.

Despite efforts by the IMF to engage the US, China, Japan, the Euro Zone and Saudi Arabia to orchestrate benign adjustments, very little progress has been made. The US still needs to reduce its external deficit through fiscal consolidation while the surplus economies in Asia and oil-exporting countries should stimulate domestic demand by boosting public expenditure and look to greater expansionary policies based on domestic demand rather than on net exports⁴. Europe should also loosen monetary policy and keep interest rates down to stimulate private demand. However, parallel progress is crucial; no government will be prepared to bear the costs of the policy initiatives needed to correct the imbalances on its own and could have negative impacts if one state moves too quickly. A gradual approach to adjusting imbalances

¹ Non oil commodity prices rose 24.7% in 2006 up from 13.4% in 2005 and are projected to rise by only 6.3% in 2007.

² Ministers should consider that a further weakening in demand for residential homes by 15% could easily slow the growth rate of the US to 0.5% which would slow world economic growth to below 2%.

³ For one, the composition of the capital inflows needed to finance the US account deficit has been shifting from equity to debt, and within debt away from treasuries to riskier forms increasing vulnerability to changes in market sentiment.

⁴ To its credit, China has tried to stimulate demand to invigorate domestic consumption by increasing the income of low-wage earners. It is also trying to slow down investments in some exports through taxation and monetary policy.

may also avoid shocking the economy with significant changes in fiscal, monetary and exchange rate policies all at once. Such a gradual approach will likely be more reassuring to financial markets, but the 'catch 22' is that investors will only be reassured if the commitment to continued adjustment is credible. In the long run, root and branch reform of the global monetary and financial system as a whole will be needed to prevent a similar constellation of imbalances from arising again, but in the interim pragmatism is urgently required, particularly as an unwinding of the yen carry trade could create further difficulties for the US dollar as demand for treasuries recede.

Needless to say, high oil prices have contributed to global imbalances by increasing the US current account deficit. While prices slackened a little in 2006, they rebounded to peak at \$80 a barrel in 2007 due to tight supplies and geopolitical instability in the Middle East and West Africa. The possibility of a recession, arising from tight monetary and other macroeconomic measures aimed to addressing oil price-induced inflation, cannot be ruled out if there is further escalation and volatility of prices. Any further shocks would disrupt the oil markets to the instant detriment of global economic growth with the impact being most severe in low-income and middle-income countries due to the higher energy intensities and a greater inflationary impact.

High oil prices have also contributed to inflation in 2007. In Africa, a number of countries saw sharp increases in consumer prices due to food shortages, currency depreciation and higher import prices for oil. Inflationary pressures in South Asia remained strong throughout 2006 due to domestic fuel prices and food prices. Meanwhile growth in oil-importing countries has lagged, especially in sub Saharan Africa where many countries fail to reach growth rates exceeding 3% GDP per capita underlining the ongoing reliance on international aid flows as a source of external finance. But international commitments are now badly off track compared to promises made in 2005 to double ODA to the region by 2010.⁵ To meet this target, donors would have to increase the flow of aid by an average annual rate of 16% over the rest of the decade. If we consider that net ODA by the 22 member DAC fell from a 'high' of 0.26% GNI in 2005 to 0.25% in 2006 we can see how far behind UN targets of 0.7% we are. Net official flows to developing countries were actually negative in 2006 on account of repayments to the IMF and other creditors standing at \$75bn, a figure significantly outstripping the \$51bn volume of grants. The revised World Bank *Africa Action Plan* rightly places emphasis on infrastructure development for water, roads, energy, transport and telecommunications, but a lack of appropriate financing instruments geared to regional projects still remains a major weakness.

Similar concerns of slashed aid budgets are spreading to 'Aid for Trade' agreements designed to boost infrastructure, institutions and investments as and adjunct to the Doha Trade Round. 'Increases' in trade related aid announced in 2005/6 only translate to a mere 10% in real terms compared to estimates made by the OECD for a 67% increase in funding. Furthermore, without the need to secure developing countries support for a trade settlement there is now a real risk that it means funding will be absorbed into normal country aid programmes (either as loans or grants) not in

⁵ The doubling was from 2004 levels.

parallel to normal aid mechanisms. Even where spending does materialise, concerns have been raised that it will be designed to promote other types of trade, notably regional or bilateral arrangements, further undermining the prospects for multilateral agreements.

Indeed, despite the latest efforts of the Trade Negotiating Committees to offer parallel concessions on agriculture and NAMA in August, the Doha talks will simply not progress unless the US and EU augment their offers to catalyse others. The US need to make cuts in (not increase) farm subsidies and to open up trade in labour services, while the EU need to do more on agricultural market access, as well as on industrial tariffs and services. Most tariffs on manufactured goods would also need to be eliminated. At the same time major developing countries would need to reduce current levels of protection for goods and services and to provide poorer developing countries with preferential market access while slashing industrial tariffs. Developing countries also need to reach greater consensus on what they should collectively contribute to the talks; recognition of the importance of services reforms to bolster productivity in their agriculture and manufacturing sectors would be a key step in this direction. But whatever comes out of the Doha Round, it is apparent that its development content has effectively been factored out the negotiations; whereas special and differential treatment for developing countries was at the heart of the talks when they began, they are now barely at the periphery.

We are already seeing protectionist sentiment gain ground through trade and investment restrictions. Washington has expended major political capital in concluding agreements with Peru, Colombia, Panama and South Korea (subject to approval), while the EU has signalled its intent to sign deals with India, South Korea and ASEAN. Within Asia itself, the number of trade deals is also increasing. ASEAN countries have all reached bilateral deals with each other, a trend closely mirrored by their agreements with China and emerging deals with India, South Korea and Japan. Australia is also actively pursuing bilateral deals in Asia. The by-product of the Doha talks' collapse will be sub optimal global growth and the economic marginalisation of some of the poorest countries and the onset of trade distorting bilateral deals with overlapping rules eroding the principle of non-discrimination.⁶ Within such deals, developing countries will ultimately lack the economic power or negotiating ability to get the best outputs by having key exports excluded. Perhaps most depressingly, with the loss of the Trade Promotion Authority in the US, it will be increasingly difficult for the Commonwealth to bring any form of effective pressure to bear to revitalise talks before 2009.

The same cannot be said of international debt relief, which still poses a number of challenges for the majority of Commonwealth members. This is not merely a case of 'fine tuning' policy initiatives, but seeking fundamental reform. On a basic level donors still need to mobilise adequate resources to help countries with substantial arrears to expedite their HIPC eligibility while also trying to increase participation of non-Paris Club and commercial creditors in providing HIPC relief. All too often commercial creditors are selling debt to vulture funds that eventually recover the debts through litigation resulting in significant financial and economic costs to

⁶ Previous economic modelling suggests that a multilateral trade agreement could yield anything between \$44bn to \$287bn developing on the degree of liberalisation and regulatory changes.

HIPCs. In the case of the Republic of Congo and Sao Tome and Principe, litigation debts have racked up to 15 and 13 per cent of GDP respectively.

A recent survey by IDA showed that of the 24 HIPCs that responded, 11 said they have been targeted with lawsuits by 44 litigating creditors with the Republic of Congo, Guyana and Uganda facing 8, 7 and 6 lawsuits respectively. Of the total of 44 litigations, 26 creditors have obtained court judgements in their favour against 7 HIPCs amounting to US\$1bn with the total reported claims under litigation amounting to US\$1.9bn which is 22% higher than the total HIPC Initiative debt relief to be provided by commercial creditors. The establishment of a HIPC Debt Clinic is a useful start for assisting Commonwealth sovereign debtors facing creditor litigation and for re-negotiating foreign debts, but more robust institutions will need to be put in place with greater input and funding from Bretton Woods Institutions. If 'impartiality' continues to paralyse effective action on the part of IFIs then at a minimum, governments where commercial creditors reside should ensure debt relief is provided on terms equivalent to the HIPC framework.

While protecting developing countries from vulture funds is fast becoming a policy imperative highlighted at the Commonwealth HIPC Ministerial in Washington DC (2007), the more fundamental problem is that MDRI compensatory finance is still based on performance based allocation formula which inevitably discriminates against IDA recipients with lower per capita incomes. The PBA gives disproportionate weighting to the Country Performance Rating, which in turn is driven by the CPIA; while these are undoubtedly useful policy hooks for the Bank to drive through its brand of governance reforms, it fundamentally fails to take poverty reduction measures into account by effectively factoring the MDGs out of the MDRI equation.

The fact that MDRI relief *still* only becomes effective only once a country attains completion point under the HIPC Initiative presses this point even harder by directly working against MDG attainment.⁷ MDRI should therefore take retroactive effect by refunding payments already made and consider de-linking MDRI from the HIPC process where more appropriate for development gains.

Given that IFIs bemoan that they simply have no incentive to progress MDRI on the basis it erodes their funding base (and indeed have gone to great lengths to minimize the benefits of MDRI by manipulating eligibility rules), donors must stump up to compensate the IFIs for their share of MDRI relief to assist LICs. Upfront payments equivalent to the capitalised sum of future debt servicing payments foregone by the IFIs on the eligible debts would be a good pressure point to prompt the Sister Banks into action, but this would require enormous political groundwork from the Commonwealth to get donors to make such a commitment. To its credit, the Commonwealth has already pushed the agenda in calling for widening the scope of MDRI to include all IDA-only countries (including those not qualifying for HIPC) to

⁷ The current policies of the IFIs have been designed to minimise the benefits of MDRI relief to HIPC's including devising eligibility rules that would reduce the number of beneficiaries, shifting backwards the cut off dates for eligible debts (as already done by the IDA and IADB) and moving forward the implementation date (as is being done by IDA) while not relaxing the macroeconomic performance track record in the PRGF programme of the IMF that could speed up dates for countries reaching HIPC completion point.

ensure that moderately-indebted countries which fail to reach HIPC ratios still receive help. Assistance to highly-indebted Small States whose debt burdens have risen to around 84% of external debt to GNI is also a priority; it simply remains inconsistent that countries who have accumulated slightly ‘less debt’ do not qualify for relief.

Unsurprisingly, HIPC/MDRI relief or IDA grants determined through the Debt Sustainability Framework has also led to fears of cross-subsidising new lenders offering non-concessional loans known as the ‘free rider’ problem on the basis that grants and debt relief provided by IDA provide incentives for more non-concessional borrowing by LICs. While not necessarily a ‘bad thing’ as developing countries are able to convert notional debt relief figures into real investment by taking on new debt, the perennial danger is that we could see a sharp rise in unsustainable debts if not managed properly. This is particularly acute in IDA countries rich in natural resources that have easy access to non-concessional borrowing as well as countries in arrears or conflict that lack options for concessional resources; post-MDRI states could also start contracting non-concessional debts to acquire further injections of capital.

The trick will be to find a balance between oversight of LIC borrowing practices while allowing for ownership of development programmes. But in doing so, the Commonwealth should not delude itself that commercial creditors will stick to DSF guidelines as proposed by the World Bank in their latest policy documents on anti-free riding policy. This suggests that the more practical solution comes back to increasing external concessional finance to dissuade low income countries from raising non-concessional loans. Along similar lines, the World Bank should stop obsessing about being a strategic competitor with other international creditors⁸ and focus on removing the biases in the PBA allocation that makes non-concessional loans all the more likely. It should also think about how to address domestic debt that falls outside the DSF.

However, this cannot remain purely one way traffic, it is crucial that developing countries strengthen their debt management capacity alongside proper legal frameworks and fiscal responsibility laws as seen in the latest World Bank’s proposal for a global partnership to strengthen debt and macroeconomic management in LICs. Borrower countries should also pay attention to monetary management and diversify export bases while promoting economic and export growth to avoid over-valuation of domestic currencies.

The need for effective two-way partnerships can also be seen in this year’s analysis of Poverty Reduction Strategy Papers in Ghana, Malawi, Bangladesh and Tanzania from 2004-6. A major focus of the Barbados CFMM was to call for MDG centric PRSPs that give genuine ownership to developing countries and to ensure that they are tailored to realising the MDGs from a donor and recipient perspective. Yet the common theme that emerges from first generation PRSPs is that they struggled to strike the right balance between ambition and practicality in terms of ability to implement programmes amid limited capacity. Sometimes ambition was overstated

⁸ The six largest non-Paris Club bilateral creditors to LICs are Brazil, China, India, Korea, Kuwait and Saudi Arabia.

while in others, more creative programmes beyond IMF agreed macroeconomic programmes could have delivered greater development dividends.

Major concerns were also raised about the focus of PRSPs which tended to link into policies that national officials thought would play well with development partners such as health, education and social protection. This came largely at the expense of sectors critical for development and economic growth, underlined by the fact that parallel national development strategies emerged such as the 'Medium Term Plan for Growth and Poverty Reduction' in Tanzania, the 'Coordinated Programme for Economic and Social Development' in Ghana and the Malawi Economic Growth Strategy. It was only in second generation PRSPs that policies had a stronger emphasis on growth and private sector development. Even with such shifts, a number of donors still preferred to focus on direct poverty reduction measures rather than investments in infrastructure revealing an ongoing gap between donor alignment and country priorities. On a similar note, in countries eligible for HIPC debt relief it is hard to escape the conclusions that strategies were devised to gain approval by the IMF and World Bank, rather than being central national frameworks for growth and poverty reduction measures.

Irrespective of content, effective implementation of course remains the primary concern; this was certainly the case in Malawi where the PRSP went badly off track between the strategy and annual budget preparation or medium term expenditure frameworks. Tighter interaction and sequencing between finance ministries and planning ministries is thus required, as is the need for domestic accountability in the form of parliamentary scrutiny while establishing independent monitoring capabilities beyond donor offerings. Sharing institutional learning down the line would be a positive move among developing countries, but we clearly still face great difficulties of turning development discourse of country ownership into effective policy mechanisms on the ground.

3.4 Special Theme: Climate Change: The Challenges Facing Finance Ministers

The effects and impacts of climate change are already being felt. Over the past 30 years, global temperatures have risen rapidly at around 0.2°C per decade and will continue to rise over the next several decades due to past emissions. The World Health Organisation claims that global warming contributes to 150,000 deaths and 5 million illnesses each year while climatic shocks also cause setbacks to economic and social development in developing countries; the IMF, estimates costs of over 5% of GDP per large disaster on average in low-income countries between 1997 and 2001. Although less directly measurable, effects are also being felt in water stress, food insecurity, rising sea levels and an increased incidence of natural disasters linked to climate change. Nowhere are these effects felt more sharply than in Small Island States where state sovereignty is being challenged from sea level rises; long term effects of climate change across Asia, sub Saharan Africa and MENA will also have a crippling from a development perspective.⁹

⁹ The most immediate 'tipping points' will fall around degradation and depletion of agricultural land, forests, marine resources and water stress. But a key point here is that environmental scarcity is as much a function of unequal resource distribution resulting from political decisions, as it is from prevailing environmental factors. This should certainly be a consideration for all Commonwealth states in relation to equitable distribution of resources.

Time to address this looming catastrophe is short; the latest estimates from the IPCC suggest that the world has until 2020 to reverse the trend of rising greenhouse emissions to avoid some of the most dangerous effects of climate change. If emissions were to peak in 2015 (an unlikely scenario) and thereafter fall by about 50-80% over the next several decades, global warming would be limited to around 2°C above pre-industrial levels. The world has already warmed by about 0.7°C in the past century but if emissions continue to grow until 2030 (which is viewed as much more likely) the temperatures would probably rise by 3°C above pre-industrial levels. This corresponds to a level of greenhouse gases in the atmosphere equivalent to about 535 to 590 parts per million of carbon dioxide (the current concentration is 383ppm and is expected to rise by 2.5ppm every year) as a result of burning fossil fuels, deforestation and other changes in land use. At the higher levels, the likelihood of 'feedback' effects (such as thawing permafrost releasing methane) will amplify temperature rises resulting in intensified climate change as well as proximate impacts of more violent storms, desertification and a sharp reduction in agricultural productivity. The core concern is that in the absence of any effective climate change policy, changes in land use and the growth in population and energy consumption could drive greenhouse gas emissions even higher than currently estimated.

Perhaps not surprisingly, current projected costs around adaptation and mitigation of climate change vary. The IPCC provides a 'conservative' cost of cutting the world's GDP by 0.12% percentage points a year by 2030. The Stern Review differs in its argumentation by suggesting a low discount rate for calculating the net present value of future costs from not acting to mitigate climate change. Concrete policy interventions to reduce carbon emissions now would cost in the region of 1% of global output according to the report. Yet this modest figure is based on assumptions of stabilizing carbon dioxide emissions at 550 parts per million with bold assumptions that much can be done with relatively little economic pain: for instance, improving energy efficiency, halting deforestation and "decarbonising" the power sector. Such estimates are largely a function of costs based on technology and arguably fail to take account of policy costs, public goods and the system as a whole which could be significantly higher. The fact that stabilising emissions at 550ppm might also not be enough to ward off serious damage means that mitigation costs could rise well above 3.5 per cent of GDP.

Irrespective of these differentiated costs, without a significant change in policy, climate change could reduce global economic output by 20% by the end of the 21st century.¹⁰ The critical factor of keeping mitigation costs as low as possible depends on the world agreeing to cut emissions far quicker and faster than at present, which is where political traction is most critically lacking. To be successful, a global agreement on climate change would have to navigate continued resistance from the US; overcome the reluctance of developing nations to accept constraints on their economic growth; provide global economic incentives from cleaner technologies and foster co-operation on pricing, technology and the reduction of behavioural barriers around energy use and avoid harmful practices such as deforestation.

¹⁰ Even here, such a figure is merely an estimate of the present value of possible climate damage far into the future which could conceal a far greater impact on certain countries, particularly poorer, developing ones where the impact will be most felt.

Kyoto negotiations in December not only need to prolong the protocol beyond 2012, but also must try to establish a global price for carbon while securing drastic commitments to reduce emissions levels from major polluters both *within* and *outside* the protocol. Blunt realism must be the order of the day in terms of what must be achieved rather than perennial ‘green wash’ that marks the current debate.

Under the current Kyoto Protocol, the 38 countries listed in Annex 1 of the UNFCCC agreed to reduce their collective greenhouse gas emissions by approximately 5% below 1990 levels by the end of the Protocol’s first five-year commitment period (2008-12). These anaemic targets were further undermined as the Protocol favoured retention of recalcitrant states at the expense of strong targets; the Umbrella group managed to get carbon sinks into the framework helping to prevent the defection of Australia, Canada and Russia. To date, only 17 Annex B countries can be said to be on track to meet their emissions targets. It is possible that as non-compliance by one country becomes evident, non-compliance by others may gather momentum. This is underpinned by the fact that Article 18 of the treaty essentially implies that Kyoto targets are more ‘political’ than ‘legal’.

All this points towards a major compliance problem; the impending outcome from the first Kyoto period is particularly concerning given the targets in this period are highly limited raising major concerns for future negotiations. This could encourage some states to defect to an alternative approach or institution if one emerged which could lead to the Protocol’s collapse. Alternatively, and more probably, such a legitimacy crisis could lead to an intensified contest between supporters of stronger action under the existing framework and the inactive states. The Commonwealth should certainly bring pressure to bear on states such as Australia and Canada that simply need to perform better.

Increasingly, the process could thus pivot around whether Kyoto should abandon a ‘two-track’ negotiations process towards a multi-track approach. Depending on the position of the next US administration, the talks could also shift away from re-engaging Washington towards building a stronger culture of compliance by enhancing measures to reward and sanction Kyoto’s current participants. Greater focus will also be placed on expanding the Protocol’s Annex to include the emerging major emitters, China, India and Brazil albeit on a common *but* differentiated basis. In pursuing such a strategy for the second commitment period, the crunch decision will be whether it is better to accept a few defections or absences—including, if necessary, those of the high emitting states. This could also extend to removing persistently non-complying Annex B states if such actions are offset by improvements in the effectiveness of the Protocol through greater emissions coverage and stronger targets even if fewer players are sat at the table.¹¹ But agreement to extend Annex B (or to create a new annex) would come at a price. The new states, understandably, would demand considerable additional assistance to enable them to be engaged while also improving real living standards. The greater cost is that long term mitigation efforts would inevitably be limited without the world’s largest emitters onboard.

¹¹ Needless to say, ‘free rider’ problems would also create major difficulties in this respect for the functioning of the Protocol.

Ultimately until governments create the necessary policy certainty required by the private sector for investments in low carbon technologies, progress will remain illusive, particularly as markets remain unconvinced of the certainty of a long term framework to address climate change. Tackling climate change depends on a diffuse and complex system of decision-making processes with many different players, each of whom respond to a different set of incentives and risks. The crunch difficulty at the moment is that market prices signal the need for dramatic increases in the supply of hydrocarbon-based energy, while political shifts signal the need for an equally dramatic decrease in the use of this form of energy. Given markets don't really look at externalities (in this case environmental costs), they will need a clear policy steer to prioritise alternative clean energy sources in the market. But even here, it remains unclear as to how hydrocarbon producers will be persuaded to expand capacity to meet immediate energy demand while policies are being put in place to reduce longer term hydro-carbon reliance.

Long term mitigation is of course only one side of the climate change debate; adaptation is the only measure available for the impacts that will occur over the next several decades before mitigation measures can have an effect. Some adaptation will occur autonomously at an individual or firm level in response to market or environmental change, but other aspects of adaptation will require greater foresight, funding and planning.

The challenge of adaptation will be particularly acute in developing countries where greater vulnerability (measured by exposure and sensitivity) and poverty will limit capacity to act. As with longer term mitigation efforts, governments will have to play a crucial role in providing a policy framework to guide effective adaptation by individuals and firms in the medium to longer term. This will relate to land use planning, natural resource protection, coastal protection and emergency preparedness. The international community would also need to support adaptation through investments in global public goods, including improved monitoring and prediction of climate change, better modelling of regional impacts and allowing for greater flexibility in PRSPs. However, the scale of the challenge means that aid allocations to the developing world in support of adaptation through instruments such as the Adaptation Fund, Special Climate Change Fund, Least Developed Country Fund and the adaptation levy on Clean Development Mechanism will be critical; this must be in addition to ODA, not a subset.

As far as the Commonwealth is concerned, CBC proposals for a Commonwealth Carbon Trust should be rapidly brought forward to orchestrate activities; technology transfer can also play an integral role among members. Although suggestions to make climate change a 'ninth' MDG by the Commonwealth Foundation might sound politically grandiose, in the longer term, it could help to keep climate change on the agenda should oil shocks or a disorderly adjustment of global imbalances serve to delegitimise climate change initiatives. Ultimately, effective multilateral co-operation will be needed if economic growth and poverty reduction is to proceed without causing irreparable harm to the environment. The Commonwealth should extend this debate beyond the effects of the climate change to a surer footing of sustainable development to protect its weakest and most vulnerable members while not shying away from 'radical solutions'. This will be difficult, but the need for action is urgent.

3.5 Small States Issues

Not only do small states form the core membership of the Commonwealth, they also face distinct vulnerabilities that undermine their development including fast preference erosion for traditional exports and the related pressing need to be more competitive when diversify into new economic activities. The debt burden of external debt to GNI remains a key concern, as do diseconomies of scale, small domestic markets, and a narrow range of commodities undermining development prospects. With these factors in mind, the Review of the Commonwealth/World Bank Joint Task Force Report on Small States was endorsed last year in Sri Lanka to pick up the pace of policy implementation.

Policy has largely revolved around four action areas for Small States: tackling volatility, vulnerability and natural disasters; strengthening capacity; meeting challenges and opportunities of globalisation; and adapting to the changing global trade regime. The 2006 consultations confirm that these threats remain entirely valid to Small States but that the demands and risks facing them continue to grow, including compliance costs associated with efforts to combat terrorism, the sharp rise of youth unemployment, the impacts of global climate change and fresh water management issues. Transnational crime in the form of drug trafficking and illicit migration has also undermined the development and security of small states in recent years.

Although the Commonwealth resolved “to take stronger and more effective action to help vulnerable states” in the Gozo Declaration, implementation of recommendations remains mixed across the 14 key policy areas identified. Firstly, quick fixes of increased ODA have yet to properly delivered to help reposition economies towards outward orientated strategies, a problem which has been compounded by spiralling debt burdens. Small middle-income Caribbean economies are amongst the most indebted economies, while Pacific Islands are also badly afflicted. International frameworks to address such problems are still urgently needed through fiscal discipline, improved debt recording, management and restructuring, grant and concessional financing (either IDA or IBRD) - and perhaps most crucially - adequate compensation for preference erosion and support for attempts to promote private investment for diversification and growth from the WTO.

The need to build greater resilience has been extensively mapped by the Commonwealth, but translating this into macroeconomic stability, market efficiency, improved governance and social cohesion remains illusive. Labour market constraints are also hampering export-orientated strategies in terms of human resources and regulations while stymieing ‘knowledge based’ and service industries.

Small signs of regional cooperation are however starting to show as seen in the establishment of the Caribbean Single Market & Economy and the Pacific Plan. The Caribbean Catastrophe Risk Insurance Facility established in 2007 could be a useful model to role out elsewhere for improved insurance mechanisms, but even here coverage is not directly related to specific losses and reconstruction costs. Donors should therefore support a properly constituted grant financed mechanism to cover losses given high exposure to natural disasters seen most recently with hurricane Felix.

The Commonwealth must continue to focus on core issues of revised frameworks for debt problems of non-HIPC Small States, enhance the international aid architecture assisting Small States, build greater resilience and promoting diversified export bases while accounting for the new vulnerabilities. However, this can't be done alone. As Article 81 of the Mauritius Strategy noted, Small States require the 'necessary support of the international community': IFIs and regional development banks must therefore urgently make their presence felt.

3.6 Commonwealth Development Co-operation

The first generation of funds, Comafin, Kula, SARF and the Caribbean Investment Fund are almost fully divested. Comafin and SARF have achieved good returns while Kula managed to repay all its original capital to shareholders with a small return. As with the first phase of CPII, a series of regional funds are being established to cover South Asia, Africa and the Pacific Islands. In addition to Kula II and the South Asia Fund launched in 2006, Aureos has established a country fund for Malaysia raising \$25m directed at the SME sector raised predominantly through a subsidiary of Bank Negara. Kula II has now committed capital of \$16m while the South Asia Fund achieved a final close of \$85m in capital to be invested in India, Sri Lanka and Bangladesh.

Meanwhile, follow-on-funds South Asia look strong; Actis India II raised \$325m and Actis South Asia Fund II raised \$150m (including funds from OPIC). Aureos is planning to launch a \$350-400 million Pan Africa regional fund in 2008 which will invest \$60n per annum over a five year period drawn from a range of local investors, US endowments and investors from the Middle East and Asia. The Kingdom Zephyr African Management Company also plan to launch follow-on funds to PAIP/PCAP in the third quarter of 2007 moving into mining, logistics and consumer goods beyond initial investments in financial services and telecommunications.

As ministers will know, the Barbados meetings effectively mandated the second phase of CPII 2 to invest in the SME sector in high risk markets through recognition of the need to diversify developing economies. Grants from the Indian Government in 2007 to train 125 SMEs in Africa and South Asia, while welcomed, perhaps masks the largely difficulty of encouraging investment in this sector. Creating suitable domestic environments for investment remains as important as ever, but the need to forge greater collaboration between private equity, IFIs, regional development banks and domestic commercial banks to settle for more modest returns in high risk markets remains at the heart of the policy debate. On this note, although private sector capital has been increasingly tolerant of high risks in the search of greater yield, we could now see a sharp revision to 'safer' emerging markets such as the BRICs and 'Next 11' states. Even in boom years, sixty percent of all developing countries (79 of 135) never accessed the external bond market between 1980-2006 leaving the least developed countries heavily dependent on concessional loans and grants. The Commonwealth was by no means oblivious to this predicament and initiated a Task Force in 2006 to examine how the Paris Declaration for Enhancing Aid Effectiveness (2005) could be best implemented and the Commonwealth's role in doing so.

Under the declaration, donors and partner countries promised to strengthen aid effectiveness through 56 specific actions from which 12 indicators were identified

under targets set for 2010. Beyond the normal concerns of donor-driven technical cooperation and the lack of progress in untying aid, flexibility and predictability, surveys conducted by the DAC also highlighted the lack of sound operational development strategies in recipient countries to absorb, evaluate and monitor aid through results based frameworks.

To progress, partner countries need to vastly improve scrutiny of plans and make more effective use of national budgets to provide credible country priorities. From a donor perspective increased transparency and predictability in aid flows would help to facilitate this, as would aggressive efforts to reduce the transaction costs of delivery. Joint efforts from donors and recipients are urgently needed to make greater use of performance assessment frameworks and mutual accountability mechanisms. Until such plans are put in place, country ownership and accountability will be hard to substantiate. Even standardisation of reporting has yet to be achieved while the dissonance between short term allotments compared to long term gains remains stark.

The Commonwealth's drive to increase harmonisation through brokering long term agreements, mutual peer review, independent reviews and greater simplification of multilateral aid delivery through international reform (articulated in the 2006 *Action Plan*) thus remains as a formative stage. Although the Commonwealth is clearly not short of good ideas, it must speedily agree on a Charter of Best Practice and do more political groundwork at the DAC and push for the UN to play a greater role in aid delivery through the Development Cooperation Forum to orchestrate the activities of 'emerging' donors. Beijing has already committed \$10bn in concessional loans and preferential export buyer's credits to Africa over the next three years while India has committed \$500m in Export-Import lines of credit to West Africa with major increases in aid to the continent beyond 2004/5 levels. With Brazil and Russia emerging as major international donors, the need for coordination is acute to avoid making the same mistakes of the past.

Ongoing public financial management reform under ComSec's Governance and Institutional Development Division is a welcomed initiative alongside gender responsive budgeting, but it remains critical to focus on the bigger issue of effective delivery of IDA 15 disbursements, if for no other reason than to gain a greater stake in IDA 16 down the line. Most critically, low disbursement ratios must not become an excuse for failure to scale up country aid.

5 Interaction with other bodies

Despite its relatively modest size, the Commonwealth Secretariat continues to work with a diverse range of organisations. This year has seen enhanced co-operation with the Organisation Internationale de la Francophonie on making the international aid architecture more effective. The Commonwealth also continues active cooperation with the World Bank via Small States Forum and the UN General Assembly on its SIDS agenda and has progressed initiatives with the IMF, World Bank and the UN to strengthen public accounts systems. 2006 also fostered new relations with AusAID, CIDA and UNDESA while UNCTAD is growing in strategic importance for the Commonwealth to promote FDI to developing nations.

The Commonwealth has also built constructive dialogues with NEPAD the EU and a number of regional development banks including the African Development Bank, the Asian Development Bank and the Inter American Development Bank. The Paris Club and OECD countries are still key stakeholders in the development and finance world of the Commonwealth, but the greater challenge is to reach out to the London Club and indeed commercial creditors wherever possible.

Internally looking, the CFMM also works with a multitude of Commonwealth bodies including the CDC, the Commonwealth Business Council, the Commonwealth of Learning and the Commonwealth Investment Guarantee Corporation. Its linkages with the Commonwealth Foundation also allow for a strong NGOs and civil society voice. However, the strongest linkages and policy coherence firmly remains with the Commonwealth HIPC Ministerial Forum.

6 Other Issues

The obvious policy imperatives of progressing the Doha Round and ensuring the HIPC process and international aid is co-ordinated to work towards the interests of developing countries have been well documented - as have the pertinent risks embedded in the global economy - but a number of policy makers are increasingly concerned that inequality in national economies are becoming too pronounced.

Even though developing countries are closing the income gap with rich countries, many are still seeing a widening of inequality within their borders through inequitable growth. The Commonwealth should therefore consider what policies can be adopted to allow for even growth through education and institutional reform while addressing unemployment and underemployment globally. With aid allocation so high on the agenda this year, further consideration should be given to increasing development assistance for specific regions in the poorest countries. Building greater resilience for Commonwealth states heavily dependent on external capital flows should also be a policy priority in 2007 as markets consolidate their positions. Climate change, terrorism and epidemics all continue to retain the potential for massive shocks on a global level, but the impacts could be even sharper for developing states. In light of such threats, finding consensus between major emerging markets and least developed countries will be key, as will putting the politically unfashionable MDGs back at the heart of development debate.

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The Commonwealth Policy Studies Unit (www.cpsu.org.uk), part of the Institute of Commonwealth Studies, London University, began in 1999. The CPSU's mission is: to act as a think-tank for the entire Commonwealth; to stimulate debate, enquiry, and the sharing of ideas and information across the Commonwealth; to conduct a wide range of first class policy studies on issues of wide concern; and to raise the quality of policy-making by governments, inter-governmental organisations, business and civil society and local communities.

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