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2006 Commonwealth Finance Ministers' Meeting

Policy Brief

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Policy Brief for the Commonwealth Finance Ministers Meeting **12-14th September 2006**

Executive Summary

2005 promised a great deal for international development. Gains were made to increase international aid budgets to 0.7% of donors' GNI, and significant deals were brokered to widen and deepen debt relief beyond completion point HIPC's. Yet the most crucial piece of the jigsaw - a 'successful completion of the Doha Development Round' - has been hopelessly derailed as vested domestic political interests trump the demands of exporters. The Doha failure could prove to have a catastrophic impact on developing countries as they are forced to fend for themselves outside the multilateral trading system in a 'noodle bowl' of bilateral deals.

The mission for the Commonwealth in 2006 is thus threefold:-

- *first, to bring political pressure to bear to re-energise to the Doha round, failing this, the Commonwealth should attempt to salvage the best deal possible for those most vulnerable;*
- *second, to fully consolidate the gains made in 2005 on aid increases and to ensure that debt relief remains both sustainable and equitable within the prism of the MDGs;*
- *third, the Commonwealth should ensure it remains the leading international repository of innovative and practical solutions for development on the ground - particularly through encouraging poor countries to take an assertive lead when shaping their own development agendas.*

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1. Status, representation, recent meetings

The Commonwealth provides an extensive intergovernmental framework for ministerial forums, ranging from Heads of Government to education ministers. Together with the CHOGM and HIPC forums, the annual meetings of Commonwealth Finance Ministers provide a crucial forum to push for pro-poor development and harness globalisation to good effect. The CFMM meetings, most recently in Barbados, command near 100% attendance by members.

Through historical evolution and contemporary political design, the Commonwealth draws together 53 states of disparate character, ranging from wealthy industrialised members of the G8 to many of the UN-defined 'Least Developed Countries' of the world. The Commonwealth also includes a number of G20 members who are beginning to find their voice in international affairs through political engagement and burgeoning economic growth. G6 powers also rank amongst the Commonwealth membership as critical 'Doha power brokers'.

This year's CFMM meeting will take place in Sri Lanka on 12-13 September, hosted by His Excellency Mr Mahind Rajapakse, President and Minister of Finance and Planning. A week later, on 19-20th September, the World Bank and International Monetary Fund annual meetings will take place in Singapore. Finance Ministers should also bear in mind that the UN High-Level conference on Least Developed Countries is taking place at the same time as a mid-term review of the programme of action for least developed countries 2001-2010.

Commonwealth Finance ministers have much to reflect upon from the last time they met. The breakdown of the Doha development round in July will require urgent attention, involving the renewed injection of political capital. The OECD estimates that halving trade tariffs and subsidies worldwide would contribute \$44bn to the global economy, in the form of higher incomes for both producers and consumers, whilst the World Bank has also shown that an additional \$350bn could be delivered to developing countries by 2015 provided that tariffs in rich countries were reduced by 10% on agriculture and 5% on manufacturing. With such gains to be made, the Commonwealth should bring pressure to bear to recalibrate and rework the Doha discussions to the benefit of LDCs when trade ministers reconvene in Cairns and beyond.

Ministers will also need to be mindful of the pending IMF/World Bank meetings, not least as there are ongoing concerns about the Multilateral Debt Relief Initiative in relation to IDA debt. An extension of the sunset clauses, allowing all potentially eligible HIPCs sufficient time to qualify for HIPC debt relief, is also crucial to the Commonwealth, along with resolving issues about the IFIs' longer term debt sustainability frameworks. Civil society groups will be heard, both through a 'stand alone' statement and, in Sri Lanka, through the Commonwealth Foundation's Special Theme for this year, an "*Agenda for Growth and Livelihoods*" based upon the generation of domestically driven development. The Commonwealth Business Council will also provide critical perspectives on *Public-Private Partnerships for Infrastructure*.

2. Policy – the record

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 comprises the fast-growing economies of the OECD and some of the emerging 'Asian giants', and yet includes fourteen of the world's Least Developed Countries and twenty-five of the forty-six Small Island Developing States. These facts give the Commonwealth a major stake in the HIPC initiative, comprising, as it does, 10 of the 39 countries listed. Within this breadth of membership, the Commonwealth retains unique qualities of being grounded in democratic principles, development-focused, and highly supportive of pluralist societies. It also allows southern voices to carry as much weight as their industrial and post-industrial counterparts.

In the wake of the Asian currency crisis, Mauritius (1997) and Ottawa (1998) focused on the urgent need for fundamental reform of the way in which international capital are regulated, in an endeavour to avoid critical risk levels in future. The Financial Stability Forum, headed by the UK's Gordon Brown, began to allow for incremental changes to bring developing countries into the decision-making process within IFIs. The CFMM reiterated this message in Malta (2000) and it was in part been answered by the IMF and World Bank this year, when they resolved to 'reflect important changes in the weight and role of countries in the world economy'. However allowing for representation of large emerging economies is one thing, increasing Sub Saharan Africa's voting share beyond 4.4% remains another. Establishing low-income advisory groups to feed into the IFIs would be a good step in the right direction.

Having providing the intellectual stock for the HIPC initiative in the 1980s and acted as a key advocate for change since, the Commonwealth has called on the Bretton Woods Institutions both to ensure that the debt sustainability framework is aligned to achieve the MDGs and to give urgent attention to relieving the debt of other poor countries excluded from the HIPC process. In this respect, the Gleneagles G8 meeting was a notable success in establishing the Multilateral Debt Relief Initiative. But, to be effective, the process needs to go further.

London (2002) Brunei (2003) and St Nevis & Kitts (2004) maintained momentum on the primary issues of debt, aid and trade, at the same time reflecting on the promotion of 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% of GNI by 2015. On paper, the key breakthrough again came at the G8 Gleneagles Summit, ODA increasing to 0.33% of GNI, on a trajectory towards 0.7% by 2015. However, under current commitments, aid will reach only 0.36% of GNI by 2010, which is well below commitments made in the Monterrey Consensus and according to the UN Millennium Project Review is also well below the estimated \$150bn annual increase needed to reach the MDGs.

Throughout the international system, the Commonwealth remains the leading advocate of the cause of Small States of fewer than 1.5m people. Such States generally lead a precarious economic and social existence, and tend to be critically vulnerable to the vagaries of international economics. The situation is even worse for States with 'endowed handicaps' where private investment is seriously impaired by natural or man-made factors such as being landlocked, resource deficient, or in areas of intractable conflict. These handicaps all too often stack the odds against long-term growth and poverty reduction. A joint Commonwealth-World Bank task force began to think seriously about these issues in 2000. Following renewed consultations on the programme this year, key findings and recommendations will be taken back to the IFIs for consideration in light of new threats and challenges. When addressing Small State issues, the Commonwealth has also been actively engaged on the OECD's 'harmful tax practices initiative', but maintains its position that 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 work of the Barbados (2005) meetings in progressing the *Commonwealth Action Plan on Delivering the Monterrey Consensus* (2002). The Commonwealth also set itself the internal challenge of networking itself for development in 2005, a challenge that must go hand in hand with delivering the *Valletta Statement on Multilateral Trade* for small and vulnerable States.

3. Agenda for 2006

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

(1) *Election of Chairperson*

(2) *Adoption of Agenda*

(3) *Current World Economic Situation and Prospects*

An examination of the world economy's recovery in 2006 and inherent dangers including:

- High oil prices and the large global imbalances among the major economies and the US current account deficit
- The lack of progress in the Doha Round and a trend towards renewed protectionism and the increasing number of bilateral and regional trade agreements and net transfer of resources from developing countries
- The impact of the growth of China and India
- IMF/World Bank meetings with issues of relevance, including an update from the Commonwealth HIPC Minister Forum
- Concerns regarding the Multilateral Debt Relief Initiative in relation to IDA debt and extension of the sunset clause so all potentially eligible HIPCs get sufficient time to qualify for HIPC debt relief and to consider extending the scope of MDRI to include all IDA-only countries and the need for a solution to the external debt problems of non-HIPC countries with particular reference to highly indebted small states
- Discussion of the IMF exogenous shock facility of conditionality and access and long term debt sustainability frameworks for low income and conflict afflicted countries and to ensure that HIPC graduands do not reverse to unsustainable debt
- Reviews of County Owned Poverty Reduction strategies in Bangladesh and Malawi

(4) *Special Theme: "An Agenda for Growth and Livelihoods"*

Discussion of heterodox approaches to promoting sustained growth and livelihood creation in the context of globalisation to generate domestically driven development

- Input from civil society/Commonwealth Foundation
- Business perspectives from the Commonwealth Business Council

(5) *Small States Issues*

A review of the of the 2000 Report "Small States: Meeting the Challenges in the Global Economy" in light of new and emerging vulnerabilities and key messages that can be transmitted to the World Bank's Small State Forum at the Annual Meetings and to be carried through into review

(6) *Commonwealth Development Co-operation*

- A review of CDC to provide an opportunity to review progress on the Commonwealth Private Investment Initiative and the second generation funds and the Secretariat's efforts to promote investment into economies with 'endowed handicaps'.
- Review of progress in implementing the commitment by all Commonwealth Heads of Government to increase CFTC contributions by 6% in real terms for each of the next five years

4. Comments on numbered agenda items

- (3) Current World Economic Situation and Prospects

The global economy has seen steady growth of 5% GDP for 2005/6 and is forecast to maintain this into 2007 at a marginally slackened pace of 4.9%. International capital markets remain strong, and, despite recent downturns, financial markets are largely buoyant. FDI into

developing countries has also increased to \$278bn, reflecting strong growth and improved investment climates. Emerging Asia and the Pacific continue to record the most impressive levels of growth, particularly in China with forecast 9% growth. Sub-Saharan Africa will also see growth rates of 6%, underpinned by high commodity prices in the oil and mineral sectors.

Meanwhile Euro Area continues to largely under-perform, delivering growth rates of around 2.0% - a rate it will struggle to maintain in 2007. Despite strong growth in 2005, Latin American looks set to drop below the 4% mark in the next two years amidst erratic political shifts. The Newly Industrialising Asian Economies (Hong Kong, Taiwan, Singapore and Korea) also face less certain futures, struggling to maintain growth at 5%. This still outperforms Japan, which, despite recent upturns, stands at 3% optimal growth. Yet within this generally benign environment, the UN has emphasised that inequality *between* and *among* nations has markedly increased, posing longer-term risks to the global economy. The immediate causes for concern remain more proximate risks emanating from high oil prices, possibilities of higher inflationary expectations and interest rates underpinned by widening external imbalances.

Tight supplies and geopolitical instability in the Middle East have combined to push crude oil prices to nominal records of \$75 a barrel in 2006. Although the impact has been more moderate than expected thanks to continued growth and the fact that inflationary expectations have been kept in check any major shock would be likely to disrupt oil markets, to the instant detriment of global economic growth. Conservative estimates suggest that a 2mbpd supply disruption would result in the slowing of growth by 0.75% over two years, with oil prices hitting \$100 for one quarter and \$80 per barrel for a further nine months. The impact would be more severe in low-income and middle-income countries due to higher energy intensities and a greater inflationary impact. On average, the current-account position of oil importing countries would deteriorate by around 1.1% of GDP.

High oil prices have also contributed to global imbalances by increasing the US current account deficit to stand at over \$800bn (6.4% of GDP), with corresponding large surpluses in emerging Asia through export-led development strategies. The bigger story behind the imbalances is, of course, informed by different patterns of savings and a combination of shocks and economic trends across countries and regions. But few economists believe that the continued US accumulation of foreign liabilities can remain sustainable. Concrete policy interventions are therefore urgently required.

The IMF has started by establishing a *multilateral consultation* involving the US, China, Japan, the Euro Zone and Saudi Arabia, but openly admits that mitigating the risk of a disorderly adjustment in global imbalances will be a long-term process. Key actions to start with will be for the US to increase savings, and for China to allow for exchange rate appreciation in the context of greater flexibility. Europe should keep interest rates down to stimulate private demand, and greater efforts should be made to revitalize investment. Most Asian surplus countries should boost public and private investment rates, while China should also boost broad-based consumption demand. Oil-exporting countries should also look to increase capacity and diversify production structures.

A failure to achieve an orderly adjustment will result in substantial overshooting of exchange rates, a large increase in interest rates, a sharp contraction in economic activity, and intensified protectionism. This would reduce global growth by between 1% and 3%, depending on the degree of the shock. The most critical impact will be felt by developing countries. The increased current account deficits of many oil-importing developing countries make them vulnerable, whilst for heavily indebted countries the most serious threat would come from higher interest rates. For small oil-importing African countries, the largest risk is that non-oil commodity prices in metals and minerals would decline.

If surging oil prices and global imbalances provide two major threats to global economic health, the third is the increasingly stymied World Trade Talks, a situation which could undermine the entire notion of multilateral trading system. The Doha Round was suspended in late July, following a failure amongst the G6 to bridge differences over the magnitude by which farm subsidies and tariffs should be cut. A third area of contention was the extent to which developing countries should open their markets to manufacturers from industrialised nations. Together these form what Pascal Lamy termed a 'triangle' of issues, demanding parallel action. This leaves developing countries caught in the crossfire. The multilateral system has failed to provide sufficient development dividends to date, yet the alternatives, outside a multilateral system, could prove worse. The EU has been quick to call for the development aspects of the Round to be saved through the 'aid for trade' package and the abolition of farm export subsidies by 2013. Needless to say, this would be a poor substitute for the gains originally sought, but it may be the best that can realistically be hoped for.

The Commonwealth should endeavour to shift the emphasis of Doha so that, instead of being mired in competition between leading G6 players, the focus of the Round shifts back towards a development agenda for the poorest and most vulnerable States. A Doha reversion must ensure appropriate Special and Differential Treatment for developing countries are placed at the heart of multilateral negotiations to ensure they benefit from future liberalisation.

The more likely eventuality is that we will see protectionist measures being reinforced on both sides of the Atlantic and an increase in bilateral and regional trade deals. The use of regional and bilateral trade deals has increased over the past few years, with 148 of the 149 WTO members being involved in some sort of preferential trade deal. The surge in these agreements started in the early 1990s, and by July 2005 a total of 330 had been notified to the WTO. The current US administration alone has already signed 14 free trade deals, and is currently negotiating another 12. Within Asia, the number of trade deals is also increasing. The ten 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. Although trade will continue to grow under bilateral arrangements, a by-product of the Doha talks' collapse will be further trade-distorting bilateral deals, sub-optimal global growth, and the economic marginalisation of some of the poorest countries. In the context of such bilateral dealing, developing countries will ultimately lack the economic power or negotiating ability to get the best results, particularly as regards the admission of their exports.

The picture as regards external financial flows to developing countries is also of concern. Although private capital flows have increased to \$490bn and net equity flows stand at \$61.4bn, net official flows to developing countries remain negative. This is principally due to major repayments afforded to the Paris Club and IMF, set to continue into 2006/7 from Brazil, Russia and Nigeria. At the same time, we will see a significant drop in lending.

Set against this has been the rise in South-South corporate investment, which according to the World Bank's estimate stands at over \$60bn annually. A significant factor in this has been the rise of India and China. In total, Asia accounts not only for 40% of the world's population but also for a fifth of global production. China is expected to have a larger economy than the US by 2040, and the Indian economy is set to outstrip the Japanese by 2032. Their high growth rates, hunger for natural resources and growing political and economic power are re-shaping the world economy.

Both countries are rapidly integrating their huge labour forces into the world economy. For each year since 2001 their combined contribution to global output growth has been around 30%. Moreover, this contribution has helped to hold world growth above 4%, which is crucial for improving the terms of trade for primary commodity producers. From a financial

perspective, demand from Asian investors has contributed to the low level of US interest rates through the recycling of foreign exchange reserves into US securities. This has further stimulated raw material prices, impacting on raw exports from Africa. Both New Delhi and Beijing are also shifting from being recipients of international aid to major donors. China has committed to provide \$10bn in concessional loans and preferential export buyers' credits in the next three years, and is now the world's third largest donor of food aid. India is also considering increasing its provision to Africa to roughly ten times the level of 2004/5, but what remains less clear is the proportion of aid that will qualify as concessional under DAC definitions.

This brings us to an area of major concern, namely that although the rise of China and India is integral to global economic health, this growth must be carefully managed if it is to deliver optimal dividends for developing countries. Yet in Asia itself, development remains at formative stage. 309 million South Asians and Chinese will still live in poverty in 2015, compared, in real terms, to 366 million in the African continent. Even in an Asian 'Golden Era', in which growth rates continue to rise and political conflict is held in abeyance, South Asia would still, in 2015, have over 268 million people living in poverty. Should growth rates dip by a mere 1%, most Asian countries will fail to half their income poverty.

If this highlights the huge scale of the development challenge ahead, then lobbying of the IFIs must remain integral to the Commonwealth's role. The CHMF has already, in April, sent a clear message on the Multilateral Debt Relief Initiative, the ESF and the IMF/World Bank Debt Sustainability Framework, in keeping with the Lilongwe Declaration (2002) of *Ensuring Debt Sustainability and Achieving the MDGs*. In doing so, the Commonwealth has signalled its strategic aim this year to foster equality of treatment on a number of levels in the HIPC process.

On the first level, the MDRI for IDA became effective six months late, on 1st July 2006 as against 1st January, with relief granted to the 19 completion point HIPCs. Unlike the IMF and AfDF, IDA has not only chosen a later implementation date but has also shifted the cut off date for eligible debts from the end of 2004 to the end of 2003, resulting in a \$5bn loss of debt relief to HIPCs. The Commonwealth should, on the one hand, urge IDA to reconsider its position, and, on the other, should call for donors to make good any losses incurred during the IDA-14 period. In doing so, serious consideration *must* be given to emphasising MDGs rather than existing performance-based formulas for the IFIs, not least because the latter would be antithetical to the entire basis on which the MDRI was established in the first place.

Many NGOs have also been quick to note that the 2005 debt deal did not include Latin American HIPCs or lenders such as the Inter-American Development Bank, the Caribbean Development Bank or Asian Development Bank. Following political pressure from the Commonwealth, the Inter-American Development Bank is considering participation in MDRI. The Commonwealth should build on this and call for the MDRI to include all IDA only countries, so as to ensure that moderately-indebted countries which fail to reach HIPC ratios still receive help, and to allow for greater help for highly-indebted small States. As it stands, low income country debt totals \$500bn, which suggests that such countries need their debt service payments to be cut by at least \$10bn per year if they are to have any chance of reaching the interim development targets set out in the MDGs.

UN analyses also suggests that countries emerging from the HIPC process and receiving full debt relief will still have debt values far below the new ratios proposed by the World Bank-IMF thresholds in order to qualify for grant based aid. This is primarily due to outstanding debt owed to commercial creditors and other lenders beyond the Paris Club fold. The result could mean further reliance on market borrowing to fund MDG expenditures and with it, a new cycle of unsustainable debt. Within this matrix, ministers should also consider that for pre-

completion point HIPC, delivery of MDRI will become effective only once a country attains completion point. In the interim, debts that are eligible for MDRI relief could have been fully or partially repaid. Equitable solutions to this dilemma must be found through retroactive refund payments on eligible debts, and by streamlining IMF conditionality to speed up the achievement of completion point status.

If this signals major structural flaws *within* the HIPC process, major concerns also remain for its *initiation*. Many conflict-ridden states still find it difficult to get onto the initial rungs of the ladder, due to arbitrary sunset clauses. In 2004 the IMF and IDA extended the sunset clause of the Enhanced HIPC Initiative to the end of 2006, and ring fenced its application to countries satisfying the Initiative's income and indebtedness criteria using end-2004 data. This resulted in a list of 11 ring-fenced countries that must have begun an IMF/IDA- supported programme between October 1996 and December 2006. Yet five of the eleven do not meet the criteria, and another four countries are conflict-afflicted, with protracted arrears problems suggesting they will miss the December deadline. As such, the sunset clause should either be extended or abolished.

The one major policy breakthrough from last year has been the launch of the Exogenous Shock Facility established within the IMF's PRGF Trust with the aim of facilitating access to concessional financing for LICs facing sudden exogenous shocks resulting in balance of payments problems. But this too has proved to be a disappointment. A basic critique includes the fact that the facility is available only to PRGF eligible countries which did not have PRGF arrangements in place, and most critically, the upper credit tranche conditionality undermines the original purpose of the ESF, namely to provide an *immediate* response to the underlying shock. ESF's short duration means that it will also be unable to cope with most types of shock and gives it a structural inability to provide grant finance for shocks of a more permanent nature. The ESF's conditionality and limited access might also have perverse effects in stifling access to assistance and in driving countries to borrow at terms which could pose difficulties for future debt sustainability.

The Commonwealth should think beyond the ESF towards provision for poor commodity-dependent countries via a grant-financed facility. Such a facility should also not be subject to additional conditionality beyond having PSRPs, particularly as these countries find it difficult to access international capital markets and are constrained by lack of counter-cyclical liquidity. Until arrangements can be made for the rapid and automatic provision of liquidity to support growth, parallel exogenous shock facilities in the IDA and AfDF would be useful holding measures. In more general terms, considerable work still needs to be done to define debt in terms of the capacity to repay it, taking into account domestic priorities relating to human development, and configured in tandem with an ability to counter and absorb shocks.

In this respect, a major focus of the Barbados CFMM was to call for MDG-centric Poverty Reduction Strategy papers that give genuine ownership of PRSPs to developing countries and to ensure that they are tailored to realising the MDGs from a donor and a recipient perspective. Following reports from Ghana and Kenya, it was apparent that greater technical cooperation was required to turn these abstract goals into concrete policy realities. Reports from Malawi and Bangladesh serve to reinforce this message. In Bangladesh, the utility of the PRSP has been deeply contested, while in Malawi ownership of the process remained weak as it was seen as a tool to meet donor requirements rather than a development strategy deriving from domestic processes. It also failed to engage with the private sector effectively, and neglected to assess how much assistance Malawi could effectively absorb so as to make faster progress towards the MDGs. A new Malawi Growth and Development Strategy should offer significant improvements, but such case studies highlight the difficulty of turning development discourse on country ownership into effective policy mechanisms on the ground.

- (4) Special Theme: “An Agenda for Growth and Livelihoods”

The Monterrey Consensus, Millennium Summit, Gleneagles G8 Summit and the Commission for Africa all shifted attention towards international development, but they also share a conceptual consistency in believing that industrial countries can shape development in poor countries through opportunities arising from aid and debt relief. However the empirical record shows that many countries in sub-Saharan Africa and Latin America that followed ‘orthodox’ IFI policies have not performed as well as Asian economies following ‘heterodox policies’ to facilitate development and growth. Indeed, out of 117 developing countries with populations over half a million, only 12 have sustained strong per capita growth over the past two decades, nine of them in Asia. The critical factor beyond impressive growth statistics is that the growth has been employment intensive and linked to a combination of outward looking strategies with income distribution, fiscal prudence and human development measures. Meanwhile, many countries that followed IFI prescriptions for developing and transitional economies witnessed prolonged declines in output and incomes.

Heterodox countries pursue their own reforms at their own pace with the sequencing of reforms dictated by domestic considerations – for instance they might decide not to liberalise tariffs overnight but to do it in a phased way that protects their industries until they are ready for competition - as seen in China, Vietnam, Korea and Malaysia. Heterodox policies have also been highly effective in creating business opportunities for domestic investors that are tailored to local political and institutional realities. On a macro scale, developmental economists have also provided evidence to suggest that free trade agreements, liberalisation and improved market access can sometimes have perverse effects on development, as seen in Mexico and in comparisons between Vietnam and Nicaragua. That said, the Commonwealth should make it categorically clear that developed countries must not abandon poor countries to their plight: rather, they must think more creatively and innovatively about ways to give poor countries more control over economic policy through constructive development partnerships.

To this end the first generation of PRSPs had the difficult task of striking a balance between growth, poverty reduction, employment and equity. Reviews of the first generation of PRSPs have generally found they were not always focused on growth and employment in a way sufficient to reduce poverty. Indeed, the UN has repeatedly emphasised that one of the universal weaknesses in the world economy continues to be the slow growth of employment and the persistence of high rates of under-employment in most developing countries. Unless improved economic growth is reflected in increased employment, it will be difficult to reduce poverty. Greater investment must therefore be channelled into sectors with a high potential for productivity growth and employment creation, even if this means being more ambitious with fiscal and monetary policies.

One area where PRSPs have been more effective is on social sector investments in health and education from an MDG perspective. But debate continues as to whether this will ultimately be a sufficient basis for building sustainable growth to achieve poverty reduction. Second generation PRSPs are increasingly moving towards a more growth-orientated strategy - looking at investment, private sector development, environmental sustainability (including rapid urbanisation) and infrastructure development. This must also tie into public investment for rural development, so as to raise productivity through investment in roads, irrigation, and rural electrification. This is particularly important since agricultural sustainability remains the key to long term development, as stark comparisons between Africa and Asia attest.

If this helps to inform the international architecture of PRSPs, on a domestic level, any genuine *Agenda for Growth and Livelihoods* must not only emphasise the importance of sustained levels of growth, but must put a high premium on redistributive policies, fiscal transfers and infrastructure provision designed to facilitate sustainable growth. It is striking that by 2001, average PPP\$ income in Latin America was almost double that in East Asia, yet the proportion

of people in absolute poverty was slightly lower in East Asia – reflecting a less pro-poor pattern of growth and more unequal distribution of income throughout Latin America.

Enhancing participative political structures in a stable manner and encouraging the role of the private sector will also be important policy drivers, as will providing access to microfinance, developing the financial sector, and bridging the digital divide. Improved public spending and strengthening investment climates to accelerate growth will also be required. It is only with such effective firewalls in place, that the effects of climate change, natural resource depletion, the spread of diseases and the impact of economic shocks that afflict so many Commonwealth states can be coped with. Yet within this sweeping policy overview, the crucial factor to recall is that economic growth must be planned *on a country-by-country basis*, so that it takes adequate account of specific economic, social, political and cultural contexts.

- (5) Small States Issues

In 2005 the Gozo Declaration reaffirmed the Commonwealth's longstanding commitment to “to take stronger and more effective action to help vulnerable states”. Not only do Small States form a core group of Commonwealth members, they also face distinct vulnerabilities that undermine their development, including rapid preference erosion for traditional exports and the related pressing need to be more competitive and diversify into new economic activities. A rapid rise in the debt burden to 84% of external debt to GNI remains a key concern when added to the effects of diseconomies of scale, small domestic markets, and a narrow range of commodities in undermining development. It should also be noted that the average GDP growth rate for all Small States is 3.5%, compared to 4.2% for low and middle income countries with progress towards the MDGs remaining poor in African small States.

The basis of Commonwealth policy was devised with the World Bank in a Joint Task Force Report “*Small States: Meeting the Challenges in the Global Economy*” – and has seen an increasingly dense web of institutions ranging from IMF, UNCTAD, and Regional Development Banks committed to implementing the key recommendations. CFMM undertook a review of the Small States Agenda in 2005 and called for additional consultations this year to take policy considerations forward to the IMF/World Bank meetings in Singapore. Policy currently revolves 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 continue to hang over Small States but that the demands and risks of confronting them continue to grow. This includes compliance costs associated with efforts to combat terrorism, the sharp rise of youth unemployment, and the impact of global climate change. Transnational crime in the form of drug trafficking and illicit migration has also undermined the development and security of Small States in recent years. Similarly, natural disasters are an all too real problem, as witness the impact of the tsunami on the Maldives and the effects of the Caribbean hurricanes on a number of Commonwealth states.

Whilst these new vulnerabilities should not be underestimated, a major concern for Small States remains managing the transition towards export based development strategies. The Commonwealth took a leap of faith in calling for a step-change away from reliance on preferences towards a fundamental repositioning of economies towards services, finance, tourism, e-commerce and niche markets through SMEs, in order to escape the difficulties and disadvantages of traditional commodity prices. Yet this remains a difficult process to manage, both in terms of pushing for diversification and also in ensuring that the WTO takes sufficient account of the special needs of Small States that arise from the erosion of trade preferences. Special and Differential Treatment provisions must be catered for in supply-side capacity constraints of SVEs and modalities to be formulated in such a way to provide support for the diversification of the production and export base of SVEs. The principle of *less than full reciprocity*, as articulated in paragraph 16 of the Doha mandate, should also complement S&D

measures. It is likewise important for additional ODA to be made available to Small States that are repositioning their economies, to extend such assistance to lower middle income Small States, and in particular to allow MICs to draw on IBRD funds.

The 2006 Small States forum should consider setting up a permanent Small States network in close collaboration with the World Bank and the Commonwealth Secretariat, so as to provide continuity and shared best practice to compliment work already in progress. Small States should also look to develop regional cooperation wherever possible, so as to help offset transnational risks as seen in the Caribbean Single Market & Economy and the Pacific Plan. Given the risks facing Small States, very few insurance mechanisms exist for public and private assets. It is hoped that the World Bank/CARICOM Caribbean Catastrophe Risk Insurance Facility will offer a good working example to be taken forward and extended.

Thus an overall assessment suggests that policy imperatives must be widened to address core concerns of managing economic transition and also to account for the new vulnerabilities arising from globalisation. The Commonwealth will need to consolidate progress made through the Mauritius Strategy for the further implementation of the 1994 Barbados Programme of Action and to provide leadership to mainstream this into World Bank policy.

- (6) Commonwealth Development Co-operation

The Barbados meetings mandated the second phase of CPII, largely to invest in the SME sector. As with the first phase of CPII, a series of regional funds will be established to cover sub-Saharan Africa, South Asia and the Pacific Islands. The major shift in the second round of investments is focusing on the Small & Medium Enterprise (SME) sector to diversify developing economies through offering business support and additional finances. This has also become an increasingly prominent focus within the World Bank, which sees the investment-growth linkages as crucial for SMEs to provide long term employment opportunities and improvements in overall living conditions.

The Kula II Fund has \$20m committed capital and will focus on injecting capital into smaller Pacific Island countries. Due to the high costs of identifying suitable smaller business and monitoring investments once made, the technical assistance from New Zealand AID, Australia AID and the Commonwealth Secretariat has been helpful in unlocking investment capital from public institutional investors such as CDC, ADB and EIB and private investors such as ANZ Bank. Aureos has also established a fund for SMEs in South Asia which had a first close of \$40m in January 2006 and is expected to have a final close of US\$100 million later in the year. As a first step it is looking toward country funds in Bangladesh (\$15m) and Malaysia (RM250m), which could then also be extended into Brunei and regional funds for Africa. The Caribbean Fund has also now operationalised CIFIII and SAFFII has already made its first investments in Pakistan, gaining approximately \$150m in committed capital. The Pan Commonwealth African Partners Fund (launched in 2002) continues to attract impressive levels of Saudi investment, tipping it over the \$100m mark, with the Kingdom Zephyr Africa Management Company expecting investments to be concluded by September. Key returns are expected through Celtel (telecom), Lethshego (consumer lending) and Ecobank. Meanwhile, follow-on funds in South Asia have seen \$325m for Actis India 2 and \$150m for Actis Asia Fund 2.

In total, the first phase CPII has raised approximately US\$450m for investing in the emerging economies of the Commonwealth. COMAFIN was able to invest \$63.5m in a wide range of industries, with IRR increasing to 19% by the end of 2005. SARF was the largest fund, investing over \$106m in Asia with an additional \$92m in Bangladesh, India and Sri Lanka. Twenty percent returns have already been registered, with eight investments still to be realised.

Despite these strong returns, the Commonwealth is still operating against a backdrop of high risks and volatility, where attracting capital remains difficult. Critical areas in which Commonwealth governments can make a difference to the CPII is to help create suitable environments for private equity investments and to encourage public sector investment agencies within the Commonwealth to invest in the CPII 2 funds through facilitating policy changes that enable local savings institutions to invest in private equity funds. Commonwealth aid agencies can also play an important role in reducing the high cost of operating in the SME sector, while the introduction of benign tax regimes for unquoted investments would also be a significant help. Nowhere is this truer than for Small Vulnerable Economies, with endowed handicaps. In such economies, private investment is seriously handicapped by natural or man-made factors, such as being landlocked, resource deficient, or involved in intractable conflicts.

To this end the *Lowering the Threshold* initiative is also playing an important role in reducing the risk-related cost of long term outside capital by collaboration among multilateral agencies and domestic commercial banks. The result should be to facilitate an increase in the volume and sustainability of SME-scale private direct investment in commercial production of trade goods and services. Although the LTI has been initiated in the Caribbean, South Pacific and SSA through the enhanced SME financing facility, in order to maximise its impact it still needs to be better focused on business development services, the use of franchising and guarantees and to make better use of remittances. The Secretariat has been working with NEPAD to explore ways to enhance SME investment in sub-Saharan Africa. But the crucial problem still remains to forge collaboration between IFIs, regional development banks and domestic commercial banks to diversify economies, and to establish reasonable interest rates allow for more modest returns. Crucially, IFIs should provide guarantees for a substantial part of domestic commercial bank lending to qualifying SMEs, so as to reduce the overall credit risk and support SMEs on an 'as required' long-term basis.

The Commonwealth Fund for Technical Cooperation remains integral in providing assistance to member countries, especially Small States and Least Developed Countries. This spans the full array of Commonwealth interests in debt management, trade development, investment promotion, governance, public sector development, human development, gender equality and anti-money laundering measures. The widespread support from governments in increasing contributions to the CFTC by 6% per annum for the next five years in real terms now needs to be fully expedited following a secular decline in funding. A number of pledges have been made to the CFTC, and individual members continue to extend technical assistance to member countries outside the framework of the CFTC.

5. Interaction with other bodies

Despite its relatively modest size, the Commonwealth Secretariat continues to work with a diverse range of organisations. In 2006 it will be working with the Organisation Internationale de la Francophonie to discuss perspectives for making international aid architecture more effective. The Commonwealth also continues active cooperation with the World Bank via the Small States Forum and the UN General Assembly and its SIDS agenda, and has progressed initiatives with the IMF, World Bank and the UN to strengthen public accounts systems, called for in 2003. The Commonwealth has also built constructive dialogues with NEPAD, the EU and a number of regional development banks, including the African Development Bank and the Inter-American Development Bank. The Paris Club and OECD countries are still key stakeholders in the world of Commonwealth development and finance. The CFMM itself 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 links with the Commonwealth Foundation also allow for a strong voice to NGOs and civil society.

6. Other issues

The obvious policy imperatives of progressing the Doha Round and ensuring that the HIPC process is so calibrated as to work in the interests of developing countries have been well documented, along with pertinent risks affecting the global economy. However, a major risk that the Commonwealth could also consider is the possible impact of an avian flu pandemic. According to the World Bank, a serious pandemic could reduce global GDP by 5%. This would be sufficient to signify a global recession. The human cost could be even greater with deaths estimated between 14-70 million people in a worst-case scenario. High-income countries could see a 4.7% drop in GDP, developing countries 5.3%, East Asia & the Pacific 8.7%, Europe and Central Asia 9.9%, South Asia 4.9% and the Middle East & North Africa 7.0%. The overall risk remains highly limited, but effective contingency planning is nonetheless highly important.

More concrete policy considerations the Commonwealth could tackle relate to the delivery of aid budgets. Following the scaling-up of aid flows in 2005, it is now critical for donors to improve the quality of aid through better co-ordination, greater predictability and through targeting it countries and purposes that are MDG priorities. The Commonwealth, along with other organisations, has called for rapid progress in implementing the Paris Declaration for Enhancing Aid Effectiveness, through improved modalities and a stronger focus on results. Currently, aid delivery is too slow, complex and centralised. It emphasises process rather than results and mutual accountability. It is rarely delivered in a flexible, untied or predictable manner, and even when it is, recipient governments all too often lack the necessary institutions to evaluate and monitor delivery through results-based frameworks.

The Commonwealth is well placed to fix this broken system from both ends. It can do this firstly by persuading donors to improve delivery, reducing volatility through multi-year plans and commitments, and providing stronger alignment and harmonisation with national poverty reduction strategies. Secondly, it can work to increase the capacities of recipient countries to monitor and evaluate results and to increase absorption rates and capacity. It is thoroughly welcome that the technical theme of this year's meeting will focus on how aid architectures should work in different contexts and different countries.

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The Commonwealth Policy Study Unit (CPSU) began work in 1999, as an independent pan-Commonwealth policy research organisation. It remains the only think-tank dedicated entirely to Commonwealth policy issues. To date, the CPSU has conducted some 20 Projects, publishing a range of Reports and briefings, most of which have concentrated on aspects of globalisation and development, and on the Harare programme for democratisation, civil society and human rights. The CPSU is now engaged on a marked expansion of its output and reshaping of its focus. For further information about the CPSU and its publications, please visit the website: www.cpsu.org.uk

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