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IMPLEMENTATION OF ARTICLE 4, PARAGRAPHS 8 AND 9, OF THE CONVENTION

PROGRESS ON THE IMPLEMENTATION OF ARTICLE 4, PARAGRAPH 8

Report of the workshop on the needs and options of non-Annex I Parties for economic diversification, and on support programmes by Annex II Parties to address these needs

Note by the secretariat*

Summary

A workshop was held in Tehran, Iran, on 18 and 19 October 2003, on the needs and options of non-Annex I Parties for economic diversification, and on support programmes by Annex II Parties to address these needs. Discussions focused on the link between economic diversification and sustainable development, and on specific topics relating to the adverse effects of climate change and the impact of the implementation of response measures. This document also includes a list of areas identified by participants for further consideration.

* The late submission of this document is due to the delay in the organization of the workshop.

CONTENTS

I. MANDATE

1. The Conference of the Parties (COP), by its decision 5/CP.7, requested the secretariat to organize a workshop, before the ninth session of the COP, on the needs and options of Parties not included in Annex I to the Convention (non-Annex I Parties) for economic diversification, and on support programmes by Annex II Parties to address these needs, and to report the results of this workshop to the COP at its ninth session.

II. WORKSHOP PROCEEDINGS

2. The workshop was held from 18 to 19 October 2003 in Tehran, Iran, and was hosted by the Islamic Republic of Iran, with financial support by the Government of Canada. It was chaired by Ms. Daniela Stoycheva, Chair of the Subsidiary Body for Implementation (SBI). The workshop was attended by 40 participants from Parties, international organizations and research institutions. A background paper providing an overview of economic diversification in the context of climate change was made available by the secretariat at the start of the workshop.[1]

3. The workshop focused on the following:

(a) A general overview on economic diversification;

(b) Economic diversification in the context of the adverse effects of climate change;

(c) Economic diversification in the context of the impact of the implementation of response measures;

(d) Support programmes by Annex II Parties to address developing country needs for economic diversification.

III. WORKSHOP SUMMARY

A. Overview on economic diversification

4. The discussion centred on economic diversification as it refers to the diversification of products and exports, and subsequently increasing the diversity of sources of revenue. It is conventionally measured by the share of manufacturing in GDP and/or in total merchandise exports. The Economic Diversification Index of the United Nations Conference on Trade and Development (UNCTAD) is a composite index based on the share of manufacturing in GDP, the share of the labour force employed in industry, annual per capita commercial energy consumption and an Export Concentration Index.

5. Presentations and discussions at the workshop underscored the point that, to make economic diversification really work, related activities have to be viable and sustainable in the long term. This would require them to become important sources of export earnings and government revenue. However, it was noted in several presentations that this criterion was not met in most past efforts towards economic diversification, which has rendered such efforts unsustainable.

6. There was long discussion on the important link between economic diversification and economic development. It was suggested that the latter is, in many ways, a fuller and more complex process, encompassing not only a structural transformation of the economy (including economic diversification), but also a reduction in poverty and income disparity. Moreover, it implies progress in values, attitude and institutions, all of which are important ingredients for strengthening adaptive capacity. Thus, it was

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[1] This document, as well as presentations made at the workshop, are available at <http://unfccc.int>

argued, economic diversification cannot be pursued in isolation from sustainable development, which is key in dealing with the adverse effects of climate change and the impact of the implementation of response measures. It followed, therefore, that the issue of economic diversification in the context of climate change should be integrated into the broader framework of sustainable development.

7. In the same light, participants were generally in agreement that efforts to facilitate economic diversification can only be effective if mainstreamed into national development plans. In this regard, it was envisaged that national adaptation programmes of action (NAPAs) would play an important role in fostering economic diversification in the least developed countries (LDCs), and that an extension of such an approach could eventually be applied to non-LDC developing countries.

8. Participants also recognized that developing countries need economic diversification, even without the added problems of climate change. This is especially so for the oil-exporting countries and the LDCs, as these economies are characterized by a narrow range of economic activities – mainly hydrocarbons, agriculture and tourism. Such a narrow economic structural base not only subjects these economies to price fluctuations in export markets, but also constrains their capacity for sustainable development in the long term. The potential adverse effects that climate change may cause to some of the critically important agriculture and tourism resources, as well as the possible impacts of response measures on demand for fossil fuel exports, are added reasons for the pursuit of economic diversification.

9. Most presentations underlined that in the context of climate change, four groups are particularly affected: small island states (SIDS) (due to their increased vulnerability arising from sea-level rise and extreme weather events); LDCs (due to their lack of adaptive capacity); oil-exporting states (due to the potential impact of the implementation of response measures), and countries with a heavy dependence on the use of coal (due to the considerable burden for adaptation through fuel switching). Each of these groups faces different options and has distinct needs for economic diversification because of their differences in resource endowment, history, domestic market size, and technological and institutional capacities. Moreover, each group has had distinct experiences with economic diversification.

10. The oil-producing countries have made substantial efforts to diversify their economies since the 1970s, using their large oil revenues. However, in spite of these efforts these economies continue to rely heavily on oil (and gas) for export earning and government revenue.

11. The LDCs, in particular the SIDS among them, have also recognized the need for economic diversification, but have generally been unable to mount substantive programmes to diversify their economies. The barriers are numerous, including widespread poverty and limited economic growth, financial resources and skills to access overseas markets, trade barriers, poor infrastructure, low levels of technical and institutional capacity and the effects of recurrent natural disasters. However, some LDCs and SIDS, notably Bangladesh and Mauritius, have achieved substantial success in this endeavour by expanding labour-intensive, export-oriented manufacturing and supporting industries (including services). The ingredients for such success have included collaboration between the public and private sectors, sustained investment in both human and physical resources (including infrastructure), export orientation, the involvement of export-oriented foreign direct investment, privileged access to some developed country markets, and relatively low-cost skilled labour.

12. For heavy fossil fuel (especially coal) users such as China, the emphasis was placed on the diversification of energy sources and the introduction of more energy-efficient technologies and production processes. China has already incorporated its climate change adaptation needs into its long-term national development plans. In addition, from 2000 to 2020, when its economic output is planned to quadruple, the use of energy is expected only to double. Part of the strategy is to increase the share of natural gas and renewable energy in total energy use. However, the high costs of imported equipment, the slow pace of urbanization, and centralized control were cited as obstacles to achieving this goal.

13. Presentations and discussions showed that economic diversification might take many different forms, such as intensification of agricultural production, multi-cropping, diversification of mining activities, or the expansion of manufacturing and service industries. Even within a specific industry, there is considerable scope for diversification. For instance, tourism may be diversified through the development of new forms of tourism (e.g. rural tourism, eco-tourism and cultural tourism, as well as traditional shoreline climatic tourism).

14. In this context, mitigation activities in the context of climate change may also add to the diversity of the local economic base. For example, Indonesia is developing a programme of economic diversification in afforestation and reforestation, especially through product diversification (i.e. multi-cropping). Tree-based farming systems such as reforestation, afforestation, timber estates and agroforestry offer feasible options for carbon sequestration at a price range of US$ 5–25 per tonne. If the initial capital costs could be covered, such projects could prove attractive to small landholders.

15. Participants agreed that in the contemporary world of globalization, and because of the small size of domestic markets in many developing countries, efforts towards economic diversification would be strongly influenced by international trade conditions. Indeed, with few exceptions, it would be almost impossible for any such efforts to succeed without being able to draw on foreign technology, capital and markets. In this context, support programmes that Annex II Parties may provide to developing country Parties for economic diversification need to consist, not only of financial and technical assistance for developing structural and institutional capacity, but also of improvement of market access and facilitation of transfer of technology and inflows of private capital.

B. Economic diversification in the context of the adverse effects of climate change

16. It was recognized that the LDCs and SIDS would be strongly affected by climate change. In particular, three specific economic activities would be vulnerable: agriculture (especially food production), tourism and infrastructure. Because of a lack of economic diversity, such effects may render the entire economy vulnerable (susceptible to, or unable to cope with, adverse effects of climate change (including variability and extremes)). Nevertheless, the strengthening of adaptive capacity in the country may reduce vulnerability.

17. It was agreed that economic diversification could contribute greatly to the strengthening of adaptive capacity by reducing the exposure of these economies to climate-sensitive activities, and by enhancing the long-term economic prospects and fiscal stability of the country. However, it was recognized that such capacity will also rely on other factors, such as the availability of resources, technology, information and skills, infrastructure, institutions and equity – all of which are components of the wider context of development.

18. In this respect, the situation of the LDCs was considered particularly critical. Not only are they heavily exposed to such adverse effects due to their geography and mono-cultural economic structure, but they also have a very low level of socio-economic infrastructure, a high rate of environmental depletion, a high rate of human capital resource depletion arising from the prevalence of diseases such as AIDS, and a heavy reliance on official development assistance. There was therefore a consensus that the LDCs need to be given special attention in the area of economic diversification.

19. Presentations at the workshop pointed out that some economic diversification options (e.g. logging, shoreline tourism, greenhouse gas (GHG) emitting manufacturing) could exacerbate climate change. Therefore, it is important for developed country Parties to help developing country Parties to adopt cleaner technologies in their development endeavour and to plan and implement their diversification in such a way that both adaptation and mitigation are taken into account.

C. Economic diversification in the context of the impact of the implementation of response measures

20. Presentations showed that the world economy currently depends overwhelmingly on fossil fuels. In particular, oil is the most important energy source, and is expected to continue to be so for decades to come. Natural gas is cleaner with less emissions of GHGs and will play an increasing role as a source of energy, but its role in the future may be constrained due to higher exploration and transportation costs. The shares of hydropower and other renewable energies are expected to increase in the future but their contribution to overall energy supply will probably still be minimal by 2030. There was general consensus among participants that, given the strategic importance of oil and gas to the world economy, it was important for the developed and developing countries to work together as consumers and producers.

21. One presentation highlighted that some studies have predicted relatively limited impact of the Kyoto mechanisms on oil prices in the first commitment period (2008–2012). However, there is still considerable uncertainty regarding the trends in the demand for fossil fuels and subsequently the revenue from their exports. This is related to the fact that it is still uncertain how developed countries will decide to fulfil their Kyoto commitments, as the four competing options for doing so (joint implementation, clean development mechanism (CDM), emissions trading, and domestic policies and measures) have different impacts on energy use. This uncertainty is a cause of concern for oil-exporting countries, which are also concerned that, under the Kyoto Protocol, the trend of declining real oil price since the 1980s would continue in the future and that their economies would suffer increased revenue losses.

22. Participants agreed that there is an urgent need for economic diversification among oil-exporting countries, as such economies typically draw 70–90 per cent of export earnings and 65–75 per cent of government revenue from oil and gas. Combined with large price fluctuations, decreases in real oil prices and imminent depletion of oil reserves in several countries, such a high level of dependency translates into an unstable economic growth pattern, making it difficult to plan and implement long-term development, including adaptation to climate change.

23. On the specific challenges facing oil-exporting countries, it was recognized that these countries, specifically the member countries of the Gulf Cooperation Council (GCC), have achieved considerable success in diversifying their economies since the 1970s in terms of expanding the non-oil sector's contribution to their GDP. This has been based on the development of capital- and energy-intensive industries, supporting industries, physical and social infrastructure, and government and private services.

24. However, it was pointed out that these economic activities relied heavily on government subsidies and imported capital equipment, management and labour. They also incurred heavy environmental costs, as some of the industries are emission-heavy and make intensive use of water, a scarce natural resource in many oil-exporting countries. Oil-exporting countries thus need to re-think their economic diversification strategy in the context of climate change.

25. Some of these economies are experiencing economic difficulty. Their non-oil sectors, which lie mostly outside the manufacturing sector, make limited contributions to export earning and government revenue. With declining real oil prices, current expenditure as a percentage of GDP declined substantially in all GCC countries between 1992 and 2002. With a large wage and defence bill, this has meant that, with the exception of Bahrain and Qatar, capital expenditure as a percentage of GDP has declined substantially. Indeed, in some countries, fiscal deficits have persisted.

26. These domestic conditions are a constraint on the effort towards economic diversification. Representatives of oil-exporting countries noted that decision 5/CP.7 , paragraph 22, "encourages Annex I and non-Annex I Parties to cooperate in creating favourable conditions for investment in sectors where such investment can contribution to economic diversification". They expressed the need for developed country Parties to facilitate transfer of technology needed to make existing industries less

polluting. They also called for investment in sequestration and the exploration of alternative energy sources such as solar and wind energy. Saudi Arabia, for instance, pointed out that although it has the world's largest incidence of solar radiation, it lacks the technology and capital needed to exploit this and other clean sources of energy.

27. Presentations showed that some of the oil-exporting countries are introducing a wide range of reform measures in order to achieve economic diversification. These include a reduction in subsidies, increased competition and the encouragement of foreign direct investment (FDI) and private sector activities among others (see paragraph 33). Several countries have also established stabilization funds to deal with oil-price fluctuations. For instance, the Iranian Oil Stabilization Fund absorbs all extra income from oil revenue above planned levels, 50 per cent of which is then channelled to the private sector through the banking system to promote economic diversification. The rest is allocated to government use according to law, when planned oil revenue is not achieved as predicted.

28. Participants also discussed the most efficient way of distributing oil wealth. Past practice of spending oil wealth on economic diversification was considered very costly. It was suggested that oil-producing countries can provide the following lessons to non-oil-producing countries: do not try to 'pick the winners', but support industries that are viable and sustainable; and pay attention to the role of the government in supporting private sector development, attracting foreign direct investment and further developing the financial sector to facilitate the efficient allocation of financial resources.

29. Some participants questioned the practice by some Organisation for Economic Co-operation and Development (OECD) oil-importing countries of imposing taxes on oil while at the same time subsidizing coal, a relatively more polluting fuel in the context of GHG emissions, and emphasized the need for phasing out such subsidies. Representatives from oil-exporting countries and the LDCs expressed concern that the CDM may benefit mainly the heavy coal users such as China and India. Others pointed out, however, that this is consistent with the principle of minimizing mitigation and adaptation costs by adopting the lowest cost options for dealing with climate change.

D. Limitations to achieving economic diversification goals and the role of all stakeholders

30. The goal of economic diversification has limitations. On the one hand, economic diversification is part of the larger process of economic development, which produces economic diversity as well as many other ingredients for strengthening adaptive capacity (see paragraph 6). Thus, in many ways, sustainable economic development constitutes a more appropriate goal. Nevertheless, it was argued that, given the provisions of decision 5/CP.7, especially paragraph 22, concrete steps need to be taken in order to move forward on the issue. Some participants felt that it would be useful to create an expert group on economic diversification to provide guidance in this context, and that countries should embark on the preparation of national economic diversification programmes to address issues of technology transfer, capacity-building, partnership initiatives and improvement in terms of trade.

31. In the context of climate change and in pursuing economic diversification, it was suggested that national governments in developing countries need to take longer-term perspectives and actively formulate national development plans that facilitate the growth of new economic activities that are less emission-intensive and less climate-sensitive. They also need to continue with their liberalization and privatization programmes to facilitate the shift of their oil-based economies to diversified economies that are driven by the private sector. To this end, the respective roles of national governments, foreign direct investment and development assistance need to be identified.

32. In this regard, the participants were impressed by the systematic efforts that the GCC countries have been making since the 1990s to speed up their economic diversification efforts. Many key policies have been re-assessed, including the roles of FDI, the public and private sectors, competition, administrative reform, education and training systems and labour-market reform. Key reform measures

include opening up real estate ownership to non-residents, opening up the economy to private sector initiative, eliminating taxation discrimination against FDI, encouraging self-employment and development of small- and medium-sized enterprises, and regional integration.

33. It was noted, however, that this does not necessarily mean the complete withdrawal of the state from the economy, as the private sector may lack the economic incentive and institutional capacity to effectively coordinate the efforts of economic diversification and adaptation to climate change. It was also suggested by some participants that privatization needs to be pursued with care, to make sure that the society's wider and long-term interests are safeguarded. The same applies to the role of FDI.

34. Participants also emphasised the role of development assistance and good governance in economic diversification in the context of climate change. Specific development instruments such as micro-finance and micro-insurance schemes may also have an important role to play, especially in LDCs.

IV. SUPPORT PROGRAMMES BY ANNEX II PARTIES FOR ECONOMIC DIVERSIFICATION IN NON-ANNEX I PARTIES

35. Participants discussed how the Annex II Parties may best facilitate the efforts by non-Annex I Parties towards economic diversification. In this regard, the participants from Italy and Japan both supported the view that economic diversification is not a separate process from economic development and that economic diversification should be pursued in the broad framework of sustainable development. More specifically, in the context of climate change, adaptation activities can be supported through general development work.

36. Japan proposed that activities to promote economic diversification be prioritized. There was a need for more exchange of opinions on past experiences with economic diversification and lessons learned. It would also welcome proposals based on the needs of countries willing to promote economic diversification and their national efforts in meeting such goals.

37. Japan's presentation cited several on-going collaborative projects in the area of economic diversification. These include the Saudi–Japanese Automobile Institute Project (SJAHI), the Tourism Sector Development Project in Jordan (TSDP), and the Haraz Agricultural Human Resources Development Center Project (HAHRDC) in Iran. The SJAHI aims to support the "Saudization programme" of the kingdom in the automotive labour market by helping to train a large number of automotive technicians. The TSDP encompasses six sub-projects, ranging from the development of Amman Downtown Tourism Zone to the National Museum and Dead Sea Panoramic Complex and Historic Old Salt Development. The HAHRDC functions as a technology centre for developing human resources concerned with land consolidation and rice production in consolidated land. Some participants from Africa expressed a wish to see similar projects on their continent.

38. Italy's presentation described two ongoing cooperative programmes in the context of climate change. One, a Sino–Italian cooperation programme towards sustainable development, promotes joint outputs under the framework of Rio Conventions, and consists of experimentation and testing of new innovative technologies that will eventually be scaled up to national level. The second one, the Mediterranean Renewable Energy Programme, focuses on strengthening renewable energy markets and services in developing countries and in countries with economies in transition of the Mediterranean Basin. Its objective is to implement renewable energy production capable of generating "green certificates" and/or "certified emission reductions" deriving from CDM projects. The presenter also suggested that future investment should focus on the expansion of climate-friendly energy sources, in particular the promotion of renewable energy sources, and the development of climate-friendly technologies.

V. ISSUES FOR FURTHER CONSIDERATION

39. Participants mentioned the following as possible areas for further consideration:

(a) Support for the integration of sustainable development in efforts aimed at economic diversification in developing countries;

(b) Creation of a forum for the exchange of experience in economic diversification and lessons learned, national efforts in meeting this goal, and identification of activities that can promote further economic diversification and create sustainable development opportunities;

(c) Providing support to develop structural and institutional capacity, not only through financial and technical assistance, but also through improving market assess and facilitation of technology transfer and capital inflow;

(d) Establishing special funds to facilitate national efforts for economic diversification in developing countries;

(e) Establishing broader partnerships with the private sector and civil society to better achieve expected objectives and results of economic diversification initiatives.

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