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Implementation of Article 4, paragraphs 8 and 9, of the Convention

Progress on the implementation of decision 1/CP.10

Report on the expert meeting on economic diversification

Note by the secretariat

Summary

This document provides a summary of the pre-session expert meeting on economic diversification in the context of the impact of the implementation of response measures under Article 4, paragraph 8, of the Convention, which was held in Bonn, Germany, from 16 to 17 May 2006, as mandated by decision 1/CP.10. Discussions focused on economic diversification and sustainable development in developing countries, technical support for structural and institutional capacity for economic diversification, and foreign and domestic investments and partnerships to support economic diversification. This document also includes a list of topics identified by participants as potential areas for further consideration.

CONTENTS

		<i>Paragraphs</i>	<i>Page</i>
I.	MANDATE	1	3
II.	PROCEEDINGS.....	2–4	3
III.	SUMMARY	5–34	3
	A. Overview	5–11	3
	B. Economic diversification and sustainable development in developing countries	12–21	4
	C. Technical support for structural and institutional capacity for economic diversification	22–31	6
	D. Foreign and domestic investments and partnerships to support economic diversification	32–34	7
IV.	ISSUES FOR FURTHER CONSIDERATION.....	35	8

I. Mandate

1. The Conference of the Parties (COP), by its decision 1/CP.10, requested the secretariat to organize a pre-sessional expert meeting in conjunction with the twenty-fourth session of the Subsidiary Body for Implementation, to consider how economic diversification might be integrated into and support sustainable development strategies and to discuss what technical assistance may be needed to develop structural and institutional capacity for facilitating efforts to achieve economic diversification, as well as how foreign and domestic private sector investments in these areas may be encouraged.

II. Proceedings

2. The expert meeting was held under the guidance of the Chair of the Subsidiary Body for Implementation, Mr. Thomas Becker (Denmark), from 16 to 17 May 2006 in Bonn, Germany, with Mr. Bubu Jallow (Gambia) in the chair. It was attended by 45 experts representing Parties, international organizations, research institutions and the private sector.¹

3. The meeting focused on the following main topics in addition to general issues relating to economic diversification:

- (a) Economic diversification and sustainable development in developing countries
- (b) Technical support for structural and institutional capacity for economic diversification
- (c) Foreign and domestic investments and partnerships to support economic diversification.

4. The meeting consisted of three working sessions on the above topics, which were preceded by a general discussion on economic diversification. The meeting concluded with a session during which panel discussions were held. Participants in the panel included representatives of Australia, Austria, Canada, Norway, Qatar, Saudi Arabia, Tuvalu and the United Kingdom of Great Britain and Northern Ireland, as well as experts from the Arab Planning Institute and the World Resources Institute.

III. Summary

A. Overview

5. Overview presentations provided a backdrop for the issue of economic diversification in the context of the implementation of response measures to climate change. The presenters emphasized that the need for economic diversification is driven by a need to reduce the high dependency of developing countries on the income from single commodities such as fossil fuels. This dependency exacerbates the vulnerability of these countries to the adverse effects of policies and measures being undertaken by Parties included in Annex I to the Convention (Annex I Parties) to respond to climate change. Besides fossil fuel producers, least developed countries (LDCs) and small island developing States (SIDS) may also be vulnerable to the impact of response measures because of their low adaptive capacities and their lack of economic diversification. For example, environmental taxes on fuels used in air transportation might adversely affect the tourism industry – a sector on which many of the SIDS are over-dependent.

6. Although there is no common approach to economic diversification, the presenters emphasized that basic measures to foster a favourable investment climate are helpful, including efficient administration, the rule of law (especially the safeguarding of property rights), a stable macroeconomic environment, efficient and effective infrastructure and manageable political risks. Other prerequisites for

¹ The agenda, background paper and expert presentations can be found on the UNFCCC website at: http://unfccc.int/meetings/workshops/other_meetings/items/3639.php.

economic diversification mentioned were sustained efforts to improve the educational infrastructure, involvement of the private sector, and the need for governments to provide incentives and form partnerships at national and sectoral levels to bring together different types of expertise.

7. Participants suggested that countries should first learn from examples of successful economic diversification, after which they may identify trends and tailor solutions to their own national circumstances. The private sector should be allowed to choose the most promising sectors in which to invest.

8. While there was general agreement that diversification is needed to minimize the impacts of response measures, several participants expressed concern that reliable data on the impacts of response measures were not available. Other participants noted that different studies project a wide range of impacts: from no losses to annual losses of USD 19 billion for oil-exporting countries (estimates by Charles River Associates). They pointed out that so far there have been no manifestations of the adverse impacts of response measures, since oil prices have been increasing due to high demand. Some participants therefore felt that it was not clear how policies and measures undertaken by Annex I Parties would affect the global economy.

9. Participants acknowledged that economic diversification is seen as a long-term action for dealing with the impacts of response measures whereas insurance-related and risk management actions are considered to be short-term measures. It was agreed that economic diversification involves both local and global aspects: local in that it should be tailored to local circumstances, but global when national economies are highly affected by international markets. For example, the mining industry is often confronted with the problem of high fluctuations in volatile international markets, for which countries have to find ways to be resilient.

10. During the discussions a number of participants reiterated that the impacts of response measures will accelerate the need for economic diversification in developing country Parties. However, some participants also emphasized that, given the range of issues involved, the climate change process cannot by itself make a notable impact on the sustainable development efforts of the countries potentially affected by the impacts of response measures of Annex I Parties. The challenge therefore was seen as identifying those areas and modalities being pursued by Parties under Article 4, paragraphs 8 and 10, of the Convention, and the associated decisions by the COP, with a view to catalysing support by other processes.

11. Some participants highlighted that organizations such as the United Nations Conference on Trade and Development (UNCTAD), the United Nations Development Programme (UNDP) and the World Bank are currently conducting work in this area, and that the mandate of the climate change process does not preclude it from drawing on the efforts of other organizations to support its objectives. Some participants suggested that the role of the climate change process in the context of economic diversification should be to identify available mechanisms, including the clean development mechanism (CDM) and other existing initiatives that can be used to support Parties in their endeavours.

B. Economic diversification and sustainable development in developing countries

12. Participants noted that sustainable development strengthens adaptive capacity and safeguards the long-term prospects of vulnerable economies in the face of depleting natural resources and the impacts of response measures. Participants also agreed that economic diversification is only one aspect of sustainable development which enables the consideration of broader issues such as reducing poverty, improving technologies, increasing employment and ensuring the provision of ecosystem services.

13. Participants reaffirmed that sustainable development is not a one-size-fits-all concept and needs to be defined in the context of each national economy and according to particular circumstances and

priorities. As such, the pursuit of economic diversification in any country needs to be carried out according to a country-driven agenda.

14. Several success stories of economic diversification were mentioned, including the case of Qatar, which has opened its oil-and-gas sector to private investors, resulting in a thriving chemical industry, and the United Arab Emirates, which has created opportunities for the banking sector to support economic diversification in a number of sectors. Indonesia has also successfully invested its oil revenues in manufacturing and agriculture.

15. Participants also emphasized that developing human resources and moving away from depending only on revenues accrued from exporting natural resources are important elements in the enhancement of economic diversification. For example, South Korea had been investing in education infrastructure for 50 years before it achieved economic diversification.

16. Several presenters mentioned that energy regimes may be prime candidates for diversification while ensuring sustainable development. In many Parties not included in Annex I to the Convention (non-Annex I Parties) there is a clear need to transform energy regimes, with a focus both on existing operations and on new investment. The background paper prepared for this meeting noted that the International Energy Agency (IEA) forecasts indicated a need for investment of approximately USD 16 trillion in new energy infrastructure in developing countries between 2005 and 2030. Therefore supporting decisions to adopt the best available technologies are crucial if developing countries are to develop, maintain and enhance their international competitiveness in the years to come, and to meet the aspirations of their citizens with respect to energy provision.

17. According to one presenter, diversification within an existing energy sector could be achieved through a number of downstream activities such as refining and petrochemicals production, as well as coal-to-liquid and gas-to-liquid technologies. However, for such activities to be climate-friendly it is important that the carbon dioxide generated is captured.

18. Participants noted that it is possible to utilize rents from exhaustible resources for investment in substitutes for the purpose of achieving sustainable diversification in the energy sector. Examples were provided of substitutes that are inexhaustible, climate-friendly and capable of reducing the dependence on fossil fuels exports and consumption, including biomass and waste, which constitute approximately 11 per cent of the world's total primary energy supply (TPES), and hydropower which constitutes 2.3 per cent of the world's TPES or 16 per cent of the world's electricity. However, social and environmental concerns will have to be considered in the development of additional hydropower capacity. It was also mentioned that owing to high costs, renewable sources such as wind and solar energy so far provide less than 1 per cent of the world's TPES. Nonetheless, the use of wind energy is rapidly growing and the potential for solar energy is considerable.

19. As a key element in energy diversification, solar power is attractive because one billion people currently reside in areas suitable for its utilization. Concentrating solar power plants (CSP systems) have proved to be cheaper than photovoltaic technology, and fossil fuel back-up or heat storage guarantees sustained power. New technological concepts, such as the integrated solar combined cycle, direct steam generation and molten salts for heat storage and continuous power production, are in place already. The IEA envisages that in many countries solar power will become the main source of electricity by 2050. Wind energy is also a major resource, for example in Morocco, Egypt and Oman. Geothermal power is available in Turkey, the Islamic Republic of Iran, Saudi Arabia and Yemen. Major hydropower and biomass resources can be developed in Egypt, Iraq, the Islamic Republic of Iran, and Turkey.

20. Participants acknowledged that the objectives of diversification in the energy sector may be served through the development and dissemination of new technologies on a wider scale and that such

efforts should build on domestic strengths. Fossil fuel exporters might, for example, become exporters of solar expertise, given their indigenous engineering know-how in developing the petroleum sector and their favourable locations. Participants stressed that despite the aforementioned possibilities of diversification in the energy sector, not all countries lend themselves to diversification in all sectors. For example, agricultural diversification would be difficult in the Gulf countries as most of them do not have sufficient surface water and rely on non-renewable groundwater which is being overused. In this context desalination may be a good option for economic diversification.

21. Likewise, the economic options available to LDCs and SIDS are often limited to tourism, agriculture and fisheries, all of which are vulnerable to climate change. In such cases, economic diversification and sustainable development will involve trade-offs based on comparative advantages. The national adaptation programme of action process is a viable tool through which economic diversification could be promoted in LDCs.

C. Technical support for structural and institutional capacity for economic diversification

22. There was general agreement that discussions on technical support for structural and institutional capacity should be based on an understanding of the problem to be addressed, and that it was not sufficient to merely obtain support from Parties included in Annex II to the Convention (Annex II Parties), but was necessary to agree on the aims and form of any new technical assistance. Areas that could enhance the capacity for economic diversification include technology transfer, improved access to exports from developing country Parties and more trade opportunities.

23. Several participants reiterated the suggestion made at the previous workshop on economic diversification, held in 2003 in Tehran, the Islamic Republic of Iran, to establish a forum to discuss country-level and sectoral experiences on economic diversification and to identify activities that can promote further economic diversification, both in the context of vulnerability to the adverse effects of climate change and the impact of the implementation of response measures, with a view to creating sustainable development opportunities.

24. Some participants also reiterated the need to obtain assistance to leverage the necessary financial assistance through existing financial institutions, including the Global Environment Facility, the Special Climate Change Fund (SCCF) and the World Bank, and to request Annex II Parties to support the development of non-energy uses of fossil fuels in line with the provisions of decision 5/CP.7. Furthermore, participants called upon Annex II Parties to promote investment in developing countries for the development of energy sources that emit less greenhouse gas.

25. Other related areas in need of technical and financial support include the development of the key infrastructure necessary for economic activity, promotion of foreign direct investment (FDI), labour-intensive exports (manufacturing and services), access to markets in developed countries, price and ownership reforms in the energy-related industry, capacity-building, and activities and projects that promote synergy between poverty reduction, adaptation and economic diversification.

26. A representative of the European Union (EU) reported that the EU is undertaking specific activities to support economic diversification, including technological cooperation to promote the diversification of energy sources and energy efficiency, capacity-building, and the development of carbon capture and storage technology.

27. A note from the secretariat of UNCTAD indicated that it is involved in the following activities that support economic diversification both directly and indirectly:

- (a) Enabling developing countries to capture investment and trade opportunities under the CDM

- (b) Analysing the challenges and opportunities for the CDM in certain commodity sectors, such as rubber and biofuels
- (c) Assisting LDCs through UNCTAD's Special Programme for Least Developed, Landlocked and Island Developing Countries to foster CDM opportunities and promote economic diversification. This programme promotes the socio-economic development of LDCs through research, policy analysis and capacity-building
- (d) Assessing development and trade implications for oil exporting countries of the implementation of response measures.

28. The integrated framework for trade-related technical assistance to LDCs, also known as the Integrated Framework, is a model that could be used to promote economic diversification, as emphasized in one presentation. It was developed jointly by UNCTAD, the World Trade Organization, the International Monetary Fund, the International Trade Centre, UNDP and the World Bank to support LDC governments in trade, capacity-building and in integrating trade issues into national development strategies.

29. The Integrated Framework consists of four stages: first, raising awareness on the importance of trade for development; second, conducting a diagnostic trade integration study (DTIS) to identify constraints to traders, and sectors of greatest export potential, and drawing up a plan of action for integrating the national economy into the global trading system; third, integrating the plan of action into the national development plan; and fourth, implementing the plan of action in partnership with the development organizations.

30. Of particular interest for economic diversification is the DTIS stage, as it includes an analysis of the economic and export performance of the country, an assessment of the macroeconomic environment and the investment climate, and institutional issues. In addition, it provides an assessment of a number of key sectors believed to have significant potential for expansion in terms of output and trade that could be beneficial to the poor. Though the Integrated Framework is a good analytical and implementation tool, it was noted that economic diversification is wider than trade related issues.

31. The meeting acknowledged that the role of national governments of developing countries in supporting economic diversification would be limited if the financial and technical assistance provided to them is inadequate.

D. Foreign and domestic investments and partnerships to support economic diversification

32. Participants discussed how investments could facilitate the efforts by non-Annex I Parties towards economic diversification. In this regard, the background paper indicated that facilitating capital inflow and, for that matter, facilitating the flows of domestic capital for sustainable development and economic diversification depends very much on the investment climate and includes such properties as market size, quality of the labour force and infrastructure, and macroeconomic stability.

33. One presenter argued that, given the right conditions, FDI could help initiate new industries. However, the quality of the FDI is more important than the levels, in particular relating to the orientation of exports, sectoral distribution, the level of technology and marketing knowledge.

34. Participants from the EU highlighted a number of initiatives being undertaken with oil producers, including the ministerial energy dialogues since 2005, frequent round-table discussions on issues such as oil markets, energy policies, the Technology Centre in Kuwait to develop advanced fossil fuel technology, the cooperation between the EU and the Gulf Cooperation Council,² and the International Energy Forum.

IV. Issues for further consideration

35. Many participants emphasized that the issues for further consideration agreed at the 2003 Tehran workshop were still valid. In particular, participants highlighted a number of areas which merit further consideration, including:

- (a) Integration of sustainable development strategies in efforts aimed at economic diversification in developing countries;
- (b) Technical and financial assistance including through:
 - (i) Agreeing on guidance for the SCCF on economic diversification;
 - (ii) Cooperating in development, diffusion and transfer of technology;
 - (iii) Cooperating in relevant capacity-building efforts;
 - (iv) Engaging the private sector through FDI;
- (c) Establishment of a forum to discuss experiences on economic diversification and to identify activities that can promote further economic diversification both in the context of vulnerability to the adverse effects of climate change and the impact of the implementation of response measures;
- (d) Identifying how existing mechanisms and initiatives under the climate change process can contribute to economic diversification in vulnerable countries;
- (e) Taking into account economic diversification considerations in processes and organizations other than the UNFCCC, such as UNCTAD, the World Bank, the IMF, regional development banks, Commission on Sustainable Development, and dialogues between producers and consumers of fossil fuel.

² Member states are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.