

# 13. Small States and Graduation

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## 1. Introduction

The Commonwealth Secretariat (COMSEC) has played a seminal role in work associated with the vulnerability of small states and has been involved with the issue of graduation of small states from the United Nations' list of Least Developed Countries (LDCs) (Mitchell and Kisanga, 2002). Generally, these states view graduation as a shock that will have adverse repercussions on their development. As a result of this, and concomitant with the problems that small states have coping with globalisation and trade liberalisation, they offer considerable resistance to graduation.

Globalisation and trade liberalisation have accentuated graduation as an important issue for developing countries. The concerns surrounding this issue extend beyond being transferred from the list of LDCs to the list of 'more-developed countries' (MDCs) by the UN's graduation process; MDCs are also affected by graduation through the removal of special considerations with respect to financing, trade, and aid. Cognisant of the problems that graduation could impose, the UN's Economic and Social Council (ECOSOC) and its Committee for Development Policy (CDP) is in the process of developing a policy and measures for the smooth transition of graduating countries, and has indicated its willingness to work with and seek the views of other agencies in this process.

This submission presents to the CDP the views of the Commonwealth Secretariat on the graduation of small states. Small states are dominated by small island developing states (SIDS), and in this chapter these two terms are used interchangeably. The chapter examines the graduation issues of small vulnerable states, indicates future policy direction for graduation, and identifies a programme for their smooth transition. It covers:

- the graduation process and experience;
- current issues affecting the graduation of small states; and
- policy implications and measures for a smooth transition.

## 2. The graduation process and experience

There are two main types of graduation: graduation of countries from the UN category of LDCs to the category of MDCs; and graduation with respect to the loss of preferential treatment by International Financial Institutions (IFIs), such as the World Bank/IMF and regional development banks (RDBs) and bi-lateral aid organisations. This chapter concentrates on the first, the graduation of countries from the list of the least-developed countries to the list of MDCs. However, some of the arguments advanced are relevant and applicable to the second type of graduation, which affects countries in the low middle-income, or more-developed category of countries (MDCs). This type of graduation is exemplified by the World Bank's graduation of countries from concessional financing of the International Development Association (IDA). This section will therefore deal with both the UN and World Bank's policies and experience with graduation.

### 2.1 The UN's experience with graduation

The responsibility for graduating a country rests with ECOSOC and the UN General Assembly. The Committee for Development Policy (CDP) has been mandated over the past thirty years to identify which developing countries should be considered 'least developed' and which countries should be graduated. The first set of criteria for the identification of LDCs was established by the former Committee for Development Planning in 1971. In 1991 these criteria were substantially revised and consisted of gross domestic product (GDP) per capita, Augmented Physical Quality of Life Index (APQLI), and a composite economic diversification index (EDI). A rule was recommended by the CDP that in order to be graduated a country must meet two of the three criteria for at least two consecutive triennial reviews. In 1991, the General Assembly of the UN, in resolution 46/206, endorsed the criteria and the graduation rules of the CDP. The General Assembly, aware that for some countries graduation could result in a loss of welfare, incorporated the welfare principle of optimality in the resolution, which states that a graduating country should at least be not worse off than before as a result of graduation; and stressed that there was 'a need for a smooth transition of the countries graduating out of the list of LDCs with a view to avoiding a disruption of their development paths, and invited governments and international development partners to take appropriate action for a smooth transition' (UN CDP, 2001, p.47).

Based on the application of the revised criteria, Botswana was graduated from the list of least-developed countries in 1994. In a 1997 review, four countries - Vanuatu, Samoa, Cape Verde and the Maldives - were found to be eligible for graduation. In July 1998, the Committee for Development Planning was reconstituted as the Committee for Development Policy. In its first session in 1999, the CDP proposed that the least-developed category should include countries with a low per capita income, a low level of human resource development, and a high degree of economic vulnerability. The Committee therefore replaced the EDI with an economic vulnerability index (EVI). Thus, the criteria for graduation now consist of: GDP per capita; the Augmented Physical Quality of Life Index (APQLI); and an Economic Vulnerability Index (EVI). Present

requirements are: a GDP per capita of over US\$1,035; an APQLI score greater than 64; and an EVI score of less than 34.

In 2000, the four countries eligible for graduation were re-examined by the CDP on the basis of the newly adopted graduation rules. Only the Maldives was recommended for graduation, while the graduation of Cape Verde was postponed for reconsideration at the next triennial review in 2003. The CDP also recommended that Senegal be added to the list of least-developed countries. ECOSOC (Resolution 2000/34) endorsed the recommendation for Senegal but decided to defer the recommendation for the Maldives to its next substantive session in 2001. At this session, it was found that the Maldives met two of the criteria, GDP and the APQLI, and therefore was eligible for graduation. However recognising the vulnerability of the Maldives, the CDP recommended to ECOSOC that the transition period for the graduation of the Maldives be extended until the next triennial review in 2003 and to consider what special assistance might be provided for that country. ECOSOC requested the CDP 'to continue its work on the methodology to be used in the identification of the least-developed countries, where appropriate in association with other international organisations working on environmental and economic vulnerability issues' (ibid, pp.44-5).

In 2000, ECOSOC had requested (Resolution 2000/34) the UN Secretary-General to make recommendations for additional measures that could be taken to ensure a smooth transition for graduating countries. A concern affecting the measures was the likely treatment of development partners, such as the World Trade Organization (WTO), the funding organisations of the UN system, the regional development banks, and the bilateral aid agencies. None of these organisations was able to say whether its policy would change and if it did change in which respect it would do so.

In 2001, the CDP recommended that ECOSOC should request relevant development partners and multilateral organisations to make available the relevant information on their likely response to a country's graduation and to urge bilateral donors to respond to the issue of 'smooth transition' before the fourth session of the CDP in 2002. These requests, it was hoped, would enable the CDP to be in a position to evaluate the potential consequences of graduation and to identify concrete measures that could be taken to ensure a smooth transition from the least-developed country status after graduation (ibid, p.52) and to make recommendations to ECOSOC for the triennial review in 2003. However, based on discussions of the progress on work done with the UN, the CDP is not expected to put in place in 2003 a package of measures for the smooth transition of graduating countries. Nevertheless, the Maldives and Cape Verde are slated for graduation in the 2003 review.

### ***2.1.1 Botswana, a special case***

The UN's experience with graduation has demonstrated flexibility and an evolutionary approach. It is obvious from this experience that the UN does not intend to penalise countries for demonstrating good economic management by graduating them if this will result in their being worse off after graduation than before. Consequently, only

one country, Botswana, has been graduated, and it has become, because of its post-graduation performance, a model for graduation. Botswana, however, is a special case. Although the country has a high level of output volatility and a high degree of susceptibility to natural disasters, its relatively large landmass with extensive mineral and agricultural resources, along with good economic management, has more than compensated for its high degree of vulnerability. (With respect to COMSEC's environmental vulnerability index, Botswana rates in the higher medium vulnerability category of countries.) The IMF has pointed out that abundant diamond resources, coupled with sound macroeconomic policies, have enabled Botswana to achieve one of the highest rates of growth in the world. Over the past 30 years, real per capita GDP growth averaged more than 7 per cent a year, allowing Botswana to move from being one of the poorest countries in the world to a position of a middle-income country (IMF Article VI, 2002 consultation). Botswana also graduated in 1994, when the process of globalisation and trade liberalisation were less advanced. Thus, Botswana is not a good model or 'representative country' for graduation because of its national circumstances and changed external environment.

## **2.2 World Bank graduation experience and policy**

The World Bank provides assistance to poor countries to enable them to reduce poverty by growing faster, more equitably, and on a sustainable basis by means of concessional lending from the International Development Association (IDA) and eligibility-to-borrow at market rates from the International Bank for Reconstruction and Development (IBRD). When countries reach certain levels of development, they are graduated from these forms of financing.

There are currently 78 IDA-eligible countries, of which 10 are small island states (Cape Verde, Dominica, Grenada, Kiribati, Maldives, Solomon Islands, St. Lucia, St. Vincent and Vanuatu). A total of 31 countries graduated during the period 1961-99. Because of adverse developments subsequent to their graduation, eight of these graduates have been granted renewed access to IDA, leaving the total net graduates during these years at 23.

A country's eligibility for IDA resources is determined by its level of poverty and its level of creditworthiness for market borrowing from both commercial sources and from the IBRD. Per capita income, as defined by the World Bank Atlas, is IDA's basic indicator for poverty, and credit worthiness is defined as 'the ability to service new external debt at market interest over the long run'. In 2000, the ceiling for IDA eligibility, which has been revised since 1964 to account for inflation, was a per capita income of \$1,445. There are two exceptions to the per capita income operational cut off for graduation: (a) 'gap countries' - countries with incomes above the operational cut-off but which are not creditworthy for IBRD lending, and might therefore find themselves without access to either IBRD or IDA resources for their development; and (b) small island countries which face special size-related problems and which have little or no access to bank group assistance because of their limited creditworthiness for IBRD

lending. These countries are eligible for full concessionary treatment by the World Bank.

Less concessional terms are given to a third category: 'blend countries', which are countries that are IDA-eligible on the income criterion, but which have also been creditworthy for limited IBRD lending. These countries have access to IDA but are also able to borrow from the IBRD. Currently the four small islands of Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines are blend countries. IDA credits to blend countries have had 35 years maturity and 10 year's grace in comparison with 40 years maturity and 10 year's grace for IDA-only countries. This has created only a marginal difference (3 per cent) in concessionality between IDA-only and blend countries.

The process of graduation from IDA is normally triggered when a country exceeds the operational per capita income guideline. Because income levels fluctuate, countries normally begin a graduation process that lasts several (three to five ) years. This approach avoids situations in which income fluctuations could allow intermittent access to IDA financing and recognises that a sudden termination of IDA would not be desirable from a developmental point of view. When IDA determines that a country should graduate, a graduation programme is formulated consisting of:

- a phase-out for IDA lending;
- a phase-in for IBRD lending;
- special economic and sector work (ESW) and technical assistance to help address transition issues, such as improving access to commercial sources of lending;
- increased role for the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC) to improve private sector capital inflows; and
- application of triggers to accelerate the repayment of IDA credits.

Each of these measures, with the exception of the last one, is tailored to suit the particular circumstances of the country.

### **2.3. A comparative analysis of the UN and the World Bank approaches to graduation**

The experience with graduation from both the UN and the World Bank perspectives indicates that the decision to graduate a country is not an automatic one and rests on a combination of factors. There are some similarities and differences, however, between the UN and the World Bank's approaches to graduation. A comparison of both approaches reveals that the World Bank:

- has a higher per capita threshold for graduation (\$1,445 in comparison with \$1,035);
- provides special treatment for small island states and 'gap' countries (that include small states) by exempting them from the per capita cut off for graduation;

- makes provision for a longer transition period for graduation (three to five years in comparison with three for the UN); and
- has a specific programme for a smooth transition.

The World Bank has graduated many more countries than has the UN, and its experience has demonstrated that graduation can be transient in nature – about one third of the countries graduated had their old status reinstated. This comparative analysis exposes three main inadequacies of the UN's approach to graduation: (a) the criteria for graduation are limited to economic vulnerability and do not make provisions for environmental vulnerability; (b) it presently lacks a programme for a smooth transition; and (c) the transition period of three years is too short.

The criteria for graduation are evolving because of the new economic forces in the world economy and the recognition that vulnerability is an important factor in determining the development prospects of nations. The LDCs are regarded as the most vulnerable countries and so have the most difficulties coping with global exogenous factors. The UN has attempted to compensate for the effects of the new forces by extending the confidence limits on the criteria for graduation and by a consideration of special circumstances in an environmental profile of the country on the threshold of graduation. The threshold limits are 15 per cent above those for inclusion on the list. In the case of per capita GDP, this still results in a threshold that is 28 per cent lower than the World Bank's threshold for graduation.

Despite the environmental profile, the question of vulnerability is still not satisfactorily tackled. The UN's vulnerability index is an economic index (EVI) and does not capture ecological fragility. It is based on population data, the share of manufacturing and services in GDP, export concentration, agricultural instability and export instability. Despite not taking environmental vulnerability into consideration, the results from the EVI place all the states slated for graduation into the vulnerable and highly vulnerable category of countries. The UN rates countries with EVI scores between 31 and 36 as vulnerable and those over 36 as highly vulnerable. Scores for the graduation candidates were as follows: Cape Verde 56.89; Samoa 52.45; Vanuatu 41.31; and the Maldives 32.18.

### **3. Current issues affecting the graduation of small states**

The major issues of graduation for small states emanate from: (a) the loss of preferential treatment for trade, aid, and financing associated with LDC status; and (b) their vulnerability, which could jeopardise their post-graduation growth and hinder their sustainable development. These issues have been identified by SIDS as follows: (a) graduation can hinder the process of coping with and benefiting from globalisation and trade liberalisation, since the two sectors most affected by graduation are the trade sector, particularly commodity exports, and the government sector, because of the adverse effects of graduation on Official Development Assistance (ODA); (b) graduation can exert adverse influences on sustainable development; and (c), given (a) and (b), graduation could impose an added shock to their already vulnerable economies.

### **3.1 Globalisation and trade liberalisation and integration**

SIDS are experiencing serious problems adjusting to the global forces of trade liberalisation and economic integration. These two forces have brought about a new world economic regime characterised by the following.

- The creation of large world market blocs covering North America (NAFTA) and its extension to the Free Trade Area of the Americas (FTAA), Europe (EU), and Asia (APEC – the Asia-Pacific Economic Co-operation Forum).
- The decrease of external trade protection brought about by the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) and the international regulation of trade by the World Trade Organisation (WTO).
- The new worldwide economic orthodoxy, advocated and championed by the World Bank and the International Monetary Fund (IMF), whereby there is a greater reliance on market forces and private enterprise for development.

For most SIDS, trade was conducted under protected and preferential trade regimes, a legacy of their colonial past. As a result of their protected trade regimes and their economic vulnerability, SIDS have been most affected by changes in the global trading regime, particularly by the global forces of trade liberalisation and economic integration, which have been instrumental in creating the large world market blocs (Mitchell and Hinds, 1999, pp.235–44).

The liberalising of trade involves employing measures to increase international competitiveness – such as the removal of trade restrictions, the unification of effective rates of protection, and, if necessary, currency devaluation. These measures, combined with the new economic orthodoxy of curtailing government expenditure and placing a greater reliance on private enterprise for development, severely constrain the capacity of SIDS to implement actions that would solve their problems effectively. Graduation, by its effects on trade, adds another dimension to the adjustment problems faced by SIDS.

### **3.2 Graduation and sustainable development**

It has been internationally accepted that small states, because of their economic and environmental vulnerability, have peculiar developmental problems that severely affect their ability to implement the measures necessary for attaining sustainable development as recommended in UNCED's Agenda 21. This has been recognised by the Commission on Sustainable Development (CSD), and in 1994, the Barbados Programme of Action (BPOA) was developed. The BPOA called for national, regional and international action in 14 priority areas. These range from sectoral concerns such as freshwater, climate change, biodiversity, marine resources and tourism, to cross-cutting issues such as human resource development, and financing and support needed to put the plan into action (UN, 1999).

In 1999, the UN General Assembly Special Session on SIDS found that although there had been international acceptance of the BPOA, its implementation was disappoint-

ing. SIDS had established national environmental action plans (NEAPS), and there was considerable progress in strengthening regional indigenous institutions for sustainable development. At the international level, however, the level of funding necessary never materialised. The Assembly therefore called on the Secretary General to improve the existing institutional arrangements in the UN to effectively support SIDS in a more proactive way. It highlighted the impact of globalisation, trade liberalisation and the erosion and/or loss of preferential treatment in economic relations (UN, 1999b). It appealed to the highly developed countries (HDCs) to provide more tangible support to the BPOA. At the World Summit on Sustainable Development (WSSD) in Johannesburg in August–September 2002, it was acknowledged that more support was necessary for the BPOA, but there were no concrete measures to ensure that this support was forthcoming. However, there was a decision for a comprehensive review of the programme in 2004, its tenth anniversary.

The economic performance of small states has worsened with globalisation, trade liberalisation, and the pursuit of sustainable development. This can be realised by a comparison of growth rates for small states before and after 1995. From 1995–2001, World Bank/IMF data (World Bank, 2001; IMF, 1995–2001) indicated that the growth rates of GDP for most SIDS declined significantly in comparison with the growth rates for the period 1985–1994; and there was a deteriorating balance of commodity trade as growth rates for SIDS exports declined in comparison with imports. This evidence indicates that SIDS have not profited from the gains made in world trade as a result of trade liberalisation. However, graduation can exacerbate trade difficulties and growth problems for small states. Thus graduation can affect sustainable development in two ways: it can reduce growth; and it can retard growth by making it more difficult for economies to be resilient in the face of external shocks. Given the economic shocks from globalisation and trade liberalisation and from the requirements of sustainable development, there are legitimate concerns from countries selected for graduation that this will impose another serious shock on their economies.

### **3.3. The economic impact of graduation**

Graduation affects trade, aid and financing, and development. Thus its economic impact is felt most acutely in the trade and government sectors of the economy, two sectors that play leading roles in the economic development of SIDS.

#### ***3.3.1. The impact of graduation on commodity trade***

Under the GATT and the WTO, developing countries enjoy special treatment from the Generalized System of Preferences (GSP) and the Global System of Trade Preferences (GSTP). Under the GSP, developed countries offer non-reciprocal preferential treatment to products originating in the developing countries. Under the WTO there is special and differential treatment for the LDCs over and above the special provisions for developing countries, and the WTO also assists the LDCs with measures to facilitate their greater participation in its deliberations and in building up their trade

capacity. The UN and its agencies, such as UNCTAD and UNDP, provide special and differential treatment to the LDCs, such as lower membership fees and financial assistance for LDCs' representation at critical international meetings. UNCTAD provides technical assistance and market intelligence for niche markets to the LDCs.

Graduation will therefore affect the trade in goods or commodities and not the trade in services. With respect to the trade in goods, graduation will affect exports rather than imports. This will worsen the terms of trade situation, since imports generally have a high-income inelasticity, with serious ramifications for the balance of trade and payments.

### ***3.3.2. The impact of graduation on the government sector***

The impact of graduation on the government sector will be due to its effects on external sources of funding for the financing of the government's current and capital account. Donor agencies have demonstrated a preference for serving the LDCs in their programmes as the recipients most in need and deserving of aid, and many have aid programmes that offer more concessional terms to LDCs than to MDCs. There are also special programmes devoted to the LDCs by UN agencies and other bodies subsidiary to or related to the UN (e.g., IMO, ITU, UNESCO, UNCTAD, UNDP and ESCAP), by other multilateral institutions, and by bilateral donors and some international NGOs. Some of these institutions also facilitate the participation of LDCs in international conferences, seminars, and training programmes, and help donor agencies in coordinating assistance to the LDCs. With respect to assistance from UN agencies, these agencies will have to conform to UN policies for MDCs that impose more stringent conditions than do policies for the LDCs.

With the loss of concessionary financing from foreign aid, graduated countries will have to rely on non-concessionary financing and on the open market. Higher interest rates and shorter repayment periods will significantly increase the cost of capital and lower capital efficiency in the economy. In turn, this will increase the debt burden and increase the capital account deficit.

These effects will depend on whether or not there is a high dependence of government finances on trade, aid and grants and concessional loans. If there is a high dependence, graduation can adversely affect the overall government financial situation and the budget's deficit or surplus situation. SIDS are highly dependent on aid and are the highest per capita aid recipients in the world.

### ***3.3.3. The impact of graduation on the economy***

The total costs of graduation, due to their impact on trade, government operations, and the growth rate of the economy, could be significant and, even if they were not, could lead to deterioration in the economic fundamentals and place a damper on long-term growth. Graduation can push a country off its long-term growth path, from which recovery might be difficult, particularly in the short run. In fact, the main implication

of graduation is that it can impose an external shock on the graduating economy that will adversely affect future growth. **One of the major lessons emanating from the World Bank's experience with graduation is that a country should graduate when its economy is on an upturn with respect to growth of GDP. If the country is on a downturn, then the economy could slide back to its non-graduation category.**

The adverse effects of graduation are dependent on the magnitude and diversity of exports and ODA, which differ among states. SIDS, with their narrow export trade base, large government sector (with trade and government being the largest source of employment), and a relatively high aid:dependence ratio, are most likely to be adversely affected by graduation than are other countries.

The Commonwealth Secretariat's work in assisting with the preparation of the Maldives Memorandum on graduation to the UN (Appendix 1) revealed that graduation would dampen growth, and given the fact that the economy had been in a downturn in recent years, this would be a most inopportune time for graduating this country. All the countries slated for graduation, with one exception, had experienced slower and more volatile growth rates during the 2000s than before (Table 13.1).

The recent economic performance of these countries suggests unstable growth, with a resulting high probability that if these countries are graduated they could experience negative growth rates and revert to their pre-graduation status. The World Bank's experience with graduation certainly exemplifies that this phenomenon is possible.

#### **4. Policy implications of graduation and measures for a smooth transition**

The main implication of graduation is that it can impose an external shock on the graduating economy that will affect future growth. This is the reason why there has been resistance to graduation by the countries recommended for it. This resistance indicates the need for the UN to re-examine and rethink its graduation policy, as well as the requirements and measures for a smooth transition. Graduating countries also have to develop a policy and strategy for graduation and a capacity for implementing measures for a smooth transition.

**Table 13.1.** Growth rates in real GDP, graduation candidate countries, 1988–2002

	1998	1999	2000	Est. 2001	Est. 2002
	<i>Per cent</i>				
Cape Verde	7.4	8.5	6.8	3.3	4.5
Maldives	9.8	7.2	4.8	3.5	4.3
Samoa	3.4	5.6	6.8	6.0	n.a
Vanuatu	3.0	-2.1	2.5	-1.9	-0.3

*Source:* IMF Article IV consultation reports

#### **4.1. The need for rethinking UN graduation policy**

The resistance to graduation indicates the need to revisit the whole issue of LDC status and graduation, particularly in light of the problems that LDCs have and are encountering as a result of globalisation and trade liberalisation that transcend the UN classification of states. To weather the effects of globalisation, developing countries will have to increase their international competitiveness and rely more on market forces and private enterprise for development. Small states suffer from some disadvantages in this regard. There are few areas in which small states can be internationally competitive; and a recent study by COMSEC has highlighted the problems that small states have in attracting private foreign investment (Commonwealth Secretariat (2002a). This combination imposes serious constraints on small states in terms of improving their international competitiveness, particularly in the short run. Yet, the future of small states in a global context is at stake unless they can be competitive in the global marketplace. This accentuates the role of graduation and the UN's future approach to this issue.

It is recognised by international organisations, including the WTO, that developing countries will require a longer transition period for making these changes than will the developed countries. The WTO allows transition periods of 10 years' duration in certain cases. The UN's transition period for graduation is only three years, and graduation will affect the sectors that will be most vulnerable to the global forces (trade and investment). This, and other aspects of the UN's policy on graduation, suggests that the UN should change its policy on graduation. The change in policy should involve special treatment for small vulnerable states since it is essential that the UN should view small states' vulnerability as an operational rather than a theoretical concept. The two major elements of the policy change are: (a) increasing the threshold requirements for small vulnerable states by amending the criteria for their graduation, and (b) introducing measures for a smooth transition.

##### ***4.1.1. Amending the criteria for graduation of small states***

The need to amend the criteria for graduation is based on the differential treatment accorded small vulnerable states in comparison with larger ones. The measures required are the following: (a) increase the per capita income threshold for small states, and; (b) establish a composite vulnerability index by combining the results of economic and vulnerability indices.

- (a) The UN's per capita income threshold for graduation of all states should be increased to the same level as the World Bank's and a higher rate should apply to small vulnerable states. The two-tier levels should be amended on a triennial basis by ECOSOC.
- (b) The UN should replace the EVI by a composite vulnerability index based on economic and environmental indices. The Commonwealth Secretariat has developed and applied a composite vulnerability index (CVI) to developing countries (Commonwealth Secretariat (2000b). It is based on sound economic precepts and appro-

priate statistical procedures and consists of two main components: a vulnerability impact index (VII); and a resilience indicator. The vulnerability impact index covers three broad areas: economic exposure, remoteness and insularity, and susceptibility to environmental events and hazards. The Commonwealth Secretariat also provided an environmental index for developing states and island states (Aitkins et al, 2002, Annex IV) based on a number of environmental indicators selected to capture the pressures that exist on the natural environment of a particular state. These Commonwealth indices provide models for or can be adopted by the UN to establish a more comprehensive vulnerability index for graduation.

#### **4.2. UN measures for a smooth transition**

The transition constitutes a critical period in the graduation process, and this has been recognised by the UN. The two requirements for this period are for the UN to increase the transition period to five years, and to introduce specific measures to ensure a smooth transition during that period. The specific UN measures for a smooth transition are:

1. Fiscal and budgetary support. Support to governments to prevent budget deficits over the transition period will go a long way toward cushioning the effects on the government sector.
2. Access to soft funding from the World Bank/IMF and from IFIs (similar to treatment for 'countries in transition').
3. Provision of a social safety net. This could include retraining programmes if employment and job dislocations occur.
4. Encourage the participation of the international community, particularly IFIs and bilateral aid agencies, in transition programmes by establishing specific policies and programmes that are directed to the transition period.

These measures need not be universal and their applicability will depend on the particular problems faced by individual graduating states. However, a UN graduation transition programme covering a five-year period will help to allay the fears, whether real or imagined, that countries have of graduating.

#### **4.3. National measures for the smooth transition**

Recognising that graduation can impose an economic shock on graduating countries, the UN has accepted the need for a transition period. This period is currently a three-year one, and the CDP is in the process of examining measures that can be taken to ensure a smooth transition for graduating countries. However, it is not expected that these measures will be presented or put in place in the next triennial review this year. Nevertheless, the requirements for a smooth transition are those that will address the major issues of graduation. Essentially, they should enable the greater integration of the graduating countries with the global economy by means of trade liberalisation and

development assistance. Since graduation will affect trade, government, and aid, the requirements will be both external and internal. They should also make allowances for any internal dislocation in the trade and other sectors of their economies that might ensue from graduation.

With respect to trade, the need is to maintain access to traditional markets or secure access to new markets on terms that will not be disruptive to the country in transition. The national objective is that of improving international competitiveness with measures designed to attain greater efficiency in the export industries. Trade policy has to aim at increasing exports of goods and services, with services featuring prominently since this is an area in which small states can be internationally competitive. Small states will require the capacity to participate actively in trade negotiations and in the WTO.

With respect to government, the loss to government revenues from the reduction in trade and aid or in access to concessionary financing can adversely affect the budget and balance-of-payments situation. Thus it is essential that the government should pursue a sustainable development strategy, accompanied by progressive fiscal policies and measures. These policies and measures should provide for an enabling environment for private sector development which would play a crucial role in the developmental process and during the transition period.

With respect to aid, governments should make a concerted effort to attract more aid from bi-lateral and multi-lateral donor agencies. It would be useful if aid agencies viewed the transition as a period requiring special attention and were prepared to assist countries on the threshold with special programmes to assist in the transition, such as the formulation of a strategy and plan for this period. This could be patterned after disaster assistance, including short-term, specific-to-graduation issues.

These requirements for trade, government revenue and aid indicate that countries declared eligible for graduation will have to develop a strategy and programme for graduation. From a small states standpoint, it is evident that an appropriate programme for tackling graduation-related problems will require: improved negotiation capacity for small states in trade, aid and development; improved institutional capacity to plan for the effective implementation of graduation measures; and the effective implementation of measures to effect a smooth transition. These constitute further costs of graduation but they can be tempered by UN measures for a smooth transition.

#### **4.4. Strengthening the capacity to negotiate and implement graduation**

The most effective case a country can make for postponing graduation will be based on whether or not the country will be worse off as a result, in the medium and long run. If the country will be worse off, then graduation will contravene the principle of optimality in UN resolution 46/206. It is essential, therefore, that countries recommended for graduation should have an objective assessment made of the economic impacts of graduation. The UN has not developed a methodology to do so but the approach should be based on measuring the benefits and costs associated with gradua-

tion and then analysing their impact on growth and employment over the short and medium term.

In the planning phase, the country should undertake a study on the environmental and economic impact of graduation to determine the negotiating strategy and the measures to be taken to minimise the detrimental effects. In the past, UN agencies such as the UNDP have conducted impact studies on countries eligible for graduation on behalf of ECOSOC. It is important, however, that an eligible country should do its own study and, based on its findings, present its case and negotiate favourable conditions for graduating with the ECOSOC. Funds from UN or donor agencies could provide financing for this study. In the case of the Maldives, a study was done for the GOM under COMSEC's Technical Assistance Programme.

Small economies have had serious problems with effective representation at international fora due to the lack of professional negotiators and the costs involved. This has been realised by UN agencies and the WTO and they have made provisions for both participation and training. There should be similar arrangements for providing assistance for improving the negotiating capacity of small economies slated for graduation, particularly since graduation issues are so strongly related to trade issues and concerns.

#### **4.5. Main findings and recommendations**

The main findings from the analysis of the graduation issues for small vulnerable states are the following.

1. Graduation places countries in the category of 'countries in transition' but without the supporting provisions, mechanisms and services accorded these countries.
2. Graduation should be considered within the context of globalisation and trade liberalisation (WTO agreements). Although the trade in goods will be the most affected, the trade in services will also be affected by OECD regulations against harmful taxation. Small states may well be told that they cannot give concessions to attract foreign investment.
3. The UN criteria for graduation are still flexible and evolving. It is recognised that the EVI does not account adequately for vulnerability and that environmental considerations should be taken into account. The UN should combine its EVI with an appropriate environmental index for this purpose.
4. A comparison of the transitional arrangements for trade by the WTO (and for graduation by the World Bank/IMF) indicates that they are more favourable than the UN's in terms of the length of the transition period, threshold requirements, and supportive mechanisms.
5. It is obvious from the experience with graduation that the UN does not intend to penalise countries for demonstrating good economic management by graduating them, if this will result in their being worse off after graduation than before. Hence the concerns about a smooth transition. However, the CDP is not expected to put

in place, in 2003, a package of measures for the smooth transition of graduating countries. Given this situation, countries should not be graduated before these measures are in place.

6. Graduating countries have to develop a strategy to cope with graduation and with the transition period. This will require increased capacity to negotiate, manage and implement measures that will assist with a smooth transition.

Based on the above findings, the following recommendations are made by the Commonwealth Secretariat to the UN.

1. Amend the criteria for the graduation of small vulnerable countries to reflect more appropriately the constraints of their vulnerability. Specifically, their threshold requirements should be raised.
2. Extend the period of transition to five years or more.
3. Provide a transition programme based on the measures identified in this submission.
4. Seek ancillary support for the transition period from the World Bank/IMF, multilateral development banks, and bilateral donor agencies.

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# Appendix I

## The Maldivian experience with graduation

The UN recommended in 1997 that The Maldives be graduated from the list of Least Developed Countries (LDCs). Because of a conjuncture of circumstances, namely changes in the criteria for graduation and representation from the Government of the Maldives (GoM) against the recommendation for graduation, the graduation of the Maldives was postponed until 2003. However, the UN had indicated that the period from 2001 to 2003 might be the transition period for graduation of the Maldives. This appendix examines the case made by the GoM's Memorandum to the UN against graduation and the possible impact of graduation on future growth. It covers the following: (1) the economic background to graduation; (2) vulnerability and sustainable development; (3) the costs of graduation; and (4) the implications for sustainable development and growth.

### I. The economic background to graduation

The economic performance of the Maldives slowed down during the 1990s in comparison with the growth that was experienced during the 1980s. The average rate of real growth (constant 1995 Rufiyaas) for the period 1990–2000 was 7.1 per cent in comparison with 10 per cent for the 1980s. The overall economic performance increased per capita incomes and improved economic conditions. This growth was unbalanced regionally, its effects being felt mainly in Malé, leading to the perpetuation of serious regional disparities accompanied by an increased dependence on expatriate and foreign labour.

The two sectors of the economy that will be most affected by the graduation issue are trade and government operations, both of which are critical to growth and development in the Maldives.

#### I.1 Trade and government performance, 1990–2000

The trade situation during the period 1990–2000 reveals that: (a) there is a substantial imbalance in the trade of goods in the Maldives, with imports far exceeding exports; (b) there is a very favourable balance in the trade of services, where tourism predominates, but this is insufficient to bring about a favourable current account of the balance of payments; and (c) the overall balance of payments, which was positive for most of the period, relies on the inflow of capital in the form of grants, loans and remittances.

The merchandise trade of the Maldives is dominated by imports rather than by exports. Imports increased at an average rate of growth of 10.4 per cent a year during the period. In comparison, domestic exports increased at an average rate of growth of 3.6 per cent a year. This is indicative of a worsening of the terms of trade during the period, the resulting imbalance not being compensated for by the trade in services, in which tourism plays a significant role. The export trade consists of only two major commodities: fish products and textile (garments) products. The major markets are Europe and the US, respectively, and the exports enjoy preferential treatment because of LDC status.

Government plays a commanding role in the development of the Maldives, and good developmental policies and sound financial management have been largely responsible for the exceptional growth performance. The government is the largest employer of labour in the economy: over 20,000 people are employed, including security personnel. Government's total revenues and grants increased from \$46.4 million in 1990 to \$210.3 million in 2000, at an average rate of

15.1 per cent a year; and total expenditures and net lending increased from \$60.9 million to \$235.8 million, at an average rate of 13.5 per cent a year. The government sector has relied heavily on foreign assistance for the implementation of many of its programmes. However, there are problems associated with aid, which have been identified as follows: withdrawal of donors, reduction in the level of multilateral assistance, an increasing reliance on a small number of donors, and unpredictability of aid programmes.

## 2. Vulnerability and sustainable development

The UN decision to graduate the Maldives was the result of the application of new criteria for graduation. The new criteria were: GDP per capita; the Augmented Physical Quality of Life Index (APQLI); and an Economic Vulnerability Index (EVI). The Maldives met all these criteria. However, of critical concern to the Maldives is its EVI rating, which does not adequately reflect its environmental fragility. This fragility, if taken into account, would indicate that the Maldives is one of the most vulnerable countries in the world. This vulnerability has important implications for sustainable development, to which the Maldives is committed.

### 2.1 The implications of sustainable development

The pursuit of the objective of sustainable development has imposed greater responsibilities on SIDS, because of their small size and fragile environments, than on other countries. The Maldives consists of the smallest populated islands in the world, the largest island being only 5.8km<sup>2</sup>. With regard to the Maldives, the major challenges of sustainable development are the following.

1. **Protecting the marine environment.** Protecting the marine environment is critical in the Maldives because this environment constitutes the largest natural resource base for the economy. Threats to the environment arise from the activities of man and/or nature. For example, reef deterioration due to bleaching is a problem that only nature will solve, but the reefs can be protected from other threats, e.g., coral mining. Also critical is enhancing the marine infrastructure of sea defences against expected hazards – swells, rough seas, and beach erosion due to climate change.
2. **Sustainable fisheries management and development.** The fishing industry, the most productive natural resource industry, faces many problems of a biological and economic nature. Sustainable development, with its emphasis on management that is based on the precautionary principle, will impose new constraints on the industry. However, an ocean management regime, which integrates fisheries management, management of the marine environment, marine transportation, and tourism, will be essential in the Maldives where the marine industries together constitute the most important economic sector.
3. **Implementing a long-term programme for combating the effects of sea-level rise due to climate change.** It is economically impossible to save all the islands from the effects of the sea-level rise expected this century. The strategy for counteracting or minimising these effects involves concentrating on protecting strategic islands, increasing their land space where possible by sea defences and dredging, and fostering island-cluster development.
4. **Developing the financial sector and creating the enabling environment for private enterprise.** The financial sector in the Maldives is underdeveloped, dominated by four state-owned banks. Lack of competition has resulted in both little depth and inefficiencies in the sector. The GoM has recognised that the lack of a capital market and of long-term finance institutions, especially for development finance, are major constraints to private sector develop-

ment and to the establishment of a more enabling environment for private sector activity that will be crucial for future development.

5. **Good governance and strengthening the social safety net.** One of the planks of sustainable development is that of good governance. Good governance implies greater involvement of the people in the political process, and honesty, transparency and accountability in government. In the Maldives, the requirements are for administrative, fiscal and legal reform, continued improvements in the social services of education and health, and the introduction of a National Insurance scheme.

It is apparent that these challenges cannot be met without sustained economic growth, accompanied by extensive external capital, technological, and technical assistance. This has been realised by the GOM, which has developed a National Vision 2020 for the purpose of providing a long-term sustainable developmental perspective and strategy for the Maldives.

## **2.2 Medium-term growth prospects, 2001–2005**

The Sixth National Development Plan constitutes the first five-year plan to be implemented under the National Vision 2020. The Plan emphasises: (a) regional development by means of population concentration in regional North/South growth centres consisting of four Atolls each, and the establishment of a national transportation grid to serve these centres; (b) the role of the private sector in development and the necessity to create a more enabling environment in the Maldives for encouraging greater private sector activity; and (c) good governance by fiscal, administrative and legal reform and human resource development.

The IMF has recently made medium-term growth prospects for the Maldives that indicate a real growth rate of 6.1 per cent for the period 2001–05. This is well below the average real growth rate of nearly 10 per cent for the twenty-year period 1980–99. The IMF projections are postulated on the basis that graduation will take place during the period and that it will adversely affect the flow of ODA, particularly grants. However, the projections indicate that growth will be accompanied by deficits in the balance of payments, the current account and the overall balance, which is indicative of poor economic fundamentals that can affect the stability of the currency and the resilience of the economy to overcome external shocks. These aspects indicate that graduation comes at a very inopportune time for the Maldives: a period of lower growth rates and decreased resilience.

## **3. The costs of graduation**

The costs of graduation have been identified as follows.

### **(a) Loss of preferential treatment to trade and access to markets**

Under the GATT and the WTO, developing countries enjoy special treatment from the Generalized System of Preferences (GSP) and the Global System of Trade Preferences (GSTP). Under the GSP, developed countries offer non-reciprocal preferential treatment to products originating in the developing countries. Under the WTO there is special and differential treatment for the LDCs over and above the special provisions for developing countries, and the WTO also assists the LDCs with measures to facilitate their greater participation in its deliberations and in building up their trade capacity.

### **(b) Decline in foreign aid (ODA)**

Donor agencies have demonstrated a preference for serving the LDCs in their programs as the recipients most in need and deserving of aid, and many have aid programmes that offer more concessional terms to LDCs than to MDCs.

### *(c) Increased debt burden*

With the loss of concessionary financing from foreign aid, the Maldives will have to rely on non-concessionary financing and on the open market. Higher interest rates and shorter repayment periods will significantly increase the cost of capital and lower capital efficiency in the economy. In turn, this will increase the debt burden and increase the capital account deficit.

### *(d) Loss of access to other special arrangements*

There are special programmes devoted to the LDCs by UN agencies and other bodies subsidiary or related to the UN (e.g., IMO, ITU, UNESCO, UNCTAD, UNDP, ESCAP programmes in the Maldives), by other multilateral institutions, and by bilateral donors and some international NGOs. Some of these institutions also facilitate the participation of LDCs in international conferences, seminars, and training programmes, and help donor agencies in co-ordinating assistance to the LDCs. With respect to assistance from UN agencies, these agencies will have to conform to UN policies for MDCs that impose more stringent conditions than those for the LDCs.

The costs of graduation are therefore significant, impacting on trade (aid) and government operations. The macro effects of these on the economy are simulated over the medium term, i.e., the period from 2001 to 2005, assuming that graduation has taken place in 2001.

## **4. The impact on growth and development**

### **4.1. The impact of graduation on commodity trade**

Graduation will affect the trade in goods or commodities and not the trade in services, which is far more important in terms of value to the Maldives. With respect to the trade in goods, graduation will affect exports rather than imports. Fish products and garments are the only major products exported, and they accounted for 99 per cent of the value of domestic exports during the period 1990–2000. Estimates of the effects of graduation on exports from the fishing and garment industries show that the loss in export earnings from graduation could increase from \$6 million in 2001 to \$15 million in 2005. These losses will reduce the growth rate of total exports from 6.1 per cent a year to 4.8 per cent a year for the period.

### **4.2. The impact of graduation on the government sector**

The impact of graduation on the government sector will be due to its effects on external sources of funding and on the current account to compensate for these and other disruptive influences such as government financial support to fisheries (MIFCO). These effects will reduce the projected surplus on current account and increase reliance on loans. It is estimated that the costs of graduation to the GOM would average over \$7 million a year and amount to \$37 million for the period.

### **4.3. The impact of graduation on the economy**

The total costs of graduation for the Maldives, from the reduction in export revenues and costs to government, will increase from \$11.1 million in year one to \$26 million in year five. These costs have significant ramifications for the balance of payments and the government's overall balance. The impact of these costs on the growth rate of the economy is not significant, the change in the growth rate being only a 0.1 percentage point. However, graduation will lead to deterioration in the economic fundamentals and place a damper on the long-term growth of the economy.

## 5. Main findings of the analysis

The main findings from the analysis are as follows.

1. The timing for graduation could not be more inopportune for the Maldives. It comes at a time when the main challenge facing the Maldives is how to maintain high levels of growth in the face of existing external shocks from globalisation and trade liberalisation. The economy is displaying signs that it is on a point of inflection whereby the rate of growth of GDP is declining. It is apparent, however, that the challenges posed by sustainable development in the face of global forces cannot be met without sustained economic growth accompanied by extensive external capital, technological, and technical assistance.
2. The analysis of the costs of graduation indicate that the Maldives will be worse off from graduation because of its adverse effects on trade, primarily on exports of fisheries products and garments, and on government finances. This contravenes UN General Assembly Resolution 46/206, which states that graduation should not make a country worse off than before. The simulated graduation scenario indicated that although the average growth rate of GDP projected by the IMF for the period 2001–05 would not change significantly because some of the effects of graduation were taken into account in making the projections, the direct costs to the economy are estimated to be \$88.6 million for the period, or an average of \$17.7 million a year; and the increasing nature of these costs indicates that graduation will place a damper on growth in the economy over the long term.

These are the reasons why graduation is so threatening for the Maldives. Graduation could place a damper on the long-term growth path, cause severe dislocation and adverse structural transformation, and seriously impede progress on the environmental front, without which sustainable development is just not possible. Given these probabilities, the main concern is to minimise the disruptive effects of graduation and to ensure a smooth transition from LDC to MDC status for the Maldives.

### 5.1 The requirements for the smooth transition

The UN had indicated that the period from 2001 to 2003 might be the transition period for graduation of the Maldives. However, during this period, the UN will be in the process of examining measures that can be taken to ensure a smooth transition for graduating countries. To ensure that the Maldives would be able to benefit from these measures, it is desirable that the UN should not graduate the Maldives before the termination of the Sixth National Development Plan, i.e., 2005. In the meantime, there are measures that can be taken for a smooth transition of the Maldives that pertain to trade, government operations, and aid.

With respect to trade, the need is to maintain access to traditional markets or secure new markets on terms that will not be disruptive. In the Maldives, there are only two commodities that are threatened: fish products and garments. With regard to fish, the need is to tackle the problem externally and nationally. The national measures are to attain greater efficiency in the fishing industry by sustainable management, privatisation, and the reduction of post-harvest losses by improved fish handling and storage. Internationally, joint-venture marketing arrangements could circumvent tariff and non-tariff barriers in major markets.

With respect to government, fiscal reform, involving a broadening of the tax base and direct taxation, is essential in order to reduce the reliance on indirect taxation, primarily tariffs on imports. The GoM should also formulate a trade policy aimed at increasing exports of goods and services, with services featuring prominently since this is an area where the Maldives can be internationally competitive because of an educated labour force.

With respect to aid, the Maldives has to make a concerted effort to attract more bilateral and multilateral donor agencies based on its policy for sustainable development and good governance. It is essential that the Maldives be treated as an ACP country by the EU because of a historical connection to three European states: the UK, Portugal, and Holland. It would be useful if aid agencies viewed the transition as a period requiring special attention and be prepared to assist countries on the threshold with special programmes to aid the transition.

Arguably, the greatest benefit of graduation is that it makes it imperative that the GoM quicken the process of fiscal and administrative reform and concentrate more on the priorities for sustainable development. In essence, to make structural adjustments that will place the economy on a firmer foundation for growth and future development. These are in conformity with the objectives of the Sixth National Development Plan and of Vision 2020.

## **5.2 Recommendations**

Based on the findings and implications of this memorandum, the following recommendations are made to the Economic and Social Committee (ECOSOC) of the UN.

1. The Maldives should not graduate from the list of LDCs until 2005 because graduation before that time will disrupt growth and sustainable development and because the period to 2005 is a more meaningful one for attaining a smooth transition to MDC status.
2. The measures that will be most beneficial in the transition are those that concentrate on minimising the real costs of graduation. In essence, they pertain to strengthening and diversifying trade, preserving access to grants and concessional financing, and assistance (financial and technical) with the preparation of a programme and plan for graduation (with the objective of reducing the disruptive effects).