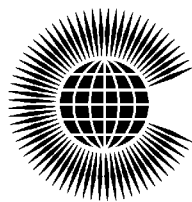


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PROMOTING INVESTMENT IN THE COMMONWEALTH: LOOKING FORWARD

Paper by the Commonwealth Secretariat

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PROMOTING INVESTMENT IN THE COMMONWEALTH LOOKING FORWARD

BACKGROUND

Private investment creates jobs and helps lift people out of poverty. Improving access to capital is therefore a priority for Commonwealth countries and the Secretariats' economic development programme. The Secretariat seeks to use the distinctive focus of the Commonwealth on its poorest and smallest members to find ways of promoting economic growth in member countries by opening the opportunities of the international economy on the one hand and to maximise the efficiency of domestic resources on the other. The Secretariats' objective is to help member countries to become more attractive destinations for foreign direct investment and develop robust indigenous capital markets.

2. Recent years have seen almost unprecedented growth in global foreign direct investment (FDI), reaching US\$1,306 billion in 2006¹ - close to the record US\$1,411 billion achieved in 2000. FDI in developing countries and transition economies reached an all time high of US\$379 billion in 2006. Worldwide growth was driven in part by increasing corporate profits and resulting higher stock prices which in turn raised the value of cross-border mergers and acquisitions. Greenfield investments also increased, particularly in developing and transition economies.

3. Africa saw FDI inflows rise to US\$36 billion, twice their 2004 level, driven by increased interest in natural resources and improvements in the business environment. FDI inflows in South and East Asia also increased to a new high of US\$200 billion, 19 % above the previous years' levels. In Latin America and the Caribbean, FDI increased 11 per cent to \$84 billion, driven by Brazil and Mexico, which received \$19 billion each. However, when investments in offshore financial centres are excluded, FDI remains at its 2005 level of \$70 billion. In the Pacific, FDI remained concentrated in the mining industry, falling 11 per cent to \$339 million.

4. In spite of this generally positive performance, the distribution of investment resources remains skewed, even between regions with similar economic performance. Africa's share of global FDI actually fell to 2.7 per cent in 2006, from 3.1 per cent a year earlier. A significant proportion of FDI worldwide remains concentrated in the natural resource sector and geographically, with four countries (China, Russia, India and Brazil) the destination for 75 per cent of all developing country FDI. Many member countries continue to face challenges in attracting investment and promoting access to capital, and the Secretariats' assistance in this regard remains relevant.

ONGOING INITIATIVES

5. The Commonwealth Secretariat seeks to assist member states to improve their investment climate and establish cost effective mechanisms to attract long term investment. The aim is to identify and pilot innovative approaches in these areas with a view to spreading good practice across the Commonwealth and to provide a demonstration effect for other investors. In response to successive mandates from Finance Ministers' meetings, the

¹ World Investment Report 2007, United Nations Conference on Trade and Development

Secretariat has focused on two key initiatives – the Commonwealth Private Investment Initiative (CPII) and Lowering the Threshold (LTT).

6. CPII aims to mobilise capital from a variety of sources, including private investors for investment in developing member countries. Three regional funds were launched in the first phase – Comafin (Sub-Saharan Africa, \$63.5 million, 1996), Kula (Pacific Islands, \$16.9 million, 1997) and the South Asia Regional Fund (SARF, \$106 million, 1998). The Tiona fund raised for the Caribbean was subsequently merged with the Caribbean Investment Fund.

7. A second phase of CPII was launched in 2005, based on a mandate from the Finance Ministers' meeting of that year. Ministers specifically requested that this phase focus on the SME sector. The Secretariat has partnered with Aureos Capital to deliver this mandate. Funds launched under this phase include Kula II (\$16 million, 2006) and the Aureos South Asia Fund (ASAF, \$85 million). A new \$400 million Africa fund was launched this year. The first closing yielded \$227.5 million. The Secretariat has supported CPII through funding for feasibility studies and facilitating negotiations with governments and potential investors including international financial institutions and local pension funds.

8. CPII has raised in excess of \$800 million for investment in member countries, including some of the most difficult investment environments. As importantly, the funds have generated good returns for shareholders. CPII was launched at a time when foreign investors were showing little interest in emerging markets. Since then, private flows to emerging markets have risen to \$300 billion in 2005, up from \$25 billion in 1990. In Africa, venture capital/private equity funds raised well over \$2 billion for investment in 2006 and again in 2007. CPII has fulfilled the twin objectives of (i) demonstrating that pre-emerging markets and small economies can offer attractive returns, and (ii) acting as a catalyst for the development of new financial products.

9. The Lowering the Threshold (LTT) initiative grew out of a 2001 Secretariat publication of the same name, which argued for the use of official development assistance to address the higher risk premium attached to investing in small vulnerable economies due to the higher cost structures associated with 'endowed handicaps'. In this regard the Secretariat facilitated a grant of US \$300,000 from NZ AID and AUS AID to support the operations of the US\$16 million Kula II fund established under CPII. The government of India also provided a grant of US \$300,000 for a training programme for middle managers of CPII investee companies. 125 participants benefitted for the programme which was delivered by the Administrative Staff College of India.

10. The Secretariat also convened a series of stakeholder meetings in Africa, the Caribbean and Pacific under LTT, bringing together international, regional and domestic financial institutions. The meetings explored practical ways in which development assistance funds channelled through the regional and international institutions could be used to support increased lending to SMEs. In all regions, they have focused on high transaction costs and risks associated with SME lending, with a particular emphasis on information asymmetries. The emphasis on SMEs under LTT has complemented the equity focus of CPII.

11. The Secretariat has therefore been exploring ways of reducing the levels of risk and transaction costs associated with lending to SME. In the 2007/08 financial year it funded a pilot SME Credit Information Database in South Africa in partnership with the International Finance Corporation (IFC), and two private sector partners, Compuscan International and

Status Credit Circle. The objective is to develop a credit information database on SME sub contractors in the building and allied industry in the Western Cape Province of South Africa. The pilot database currently contains information on approximately 7,000 SME subcontractors. Financial institutions including Alexander Forbes and ABSA have developed new products specifically for SMEs in the database, allowing them to access finance from the formal sector. Compuscan and Status have also negotiated discounts with leading suppliers of construction materials for the SMES in the database. A number of these suppliers are also beginning to extend suppliers credit facilities to the subcontractors. The database is a practical example of how information asymmetries between banks and SMEs can be addressed, including when the latter have no formal credit history or financial records. It is hoped that positive demonstration effects would serve to scale up this support to other sectors and countries in the region. The Secretariat also hopes to replicate the project in other regions, notably the Caribbean, where it also working on the issue of information asymmetries.

12. Other initiatives under LTT include research into alternatives to bank financing for SMEs, starting with leasing. Leasing provides small and medium-sized businesses that often lack the necessary collateral and credit history for traditional bank loans as a means of financing equipment. Whilst leasing accounts for 15-30 per cent of capital investment in OECD countries, it only represents an estimated 0-15 per cent in developing countries. The leasing industry in many developing countries faces structural obstacles such as an absence of clearly defined and predictable laws governing leasing transactions, unclear accounting standards, lack of an appropriate tax regime and the absence of a regulatory and supervisory framework.

13. The primary objective of the research is to assess the existing regulatory, legal and fiscal framework pertaining to financial leasing and, if necessary, provide recommendations for making this framework more conducive of financial leasing. A pilot study covering Trinidad and Tobago and Barbados was launched in February 2008 and is currently being finalised. The Secretariat intends to build on this work as described below.

NEW INITIATIVES

14. As Ministers noted in 2005, the SME sector which has a vital role in supporting long term economic development suffers from particular challenges, including a lack of long term local currency funding. Financial systems remain shallow and access is limited, especially outside urban centres. High transaction costs both during appraisal and monitoring of investments continue to deter investors in many markets.

15. In recognition of these challenges, Commonwealth Heads of Government, in their communiqué issued in Kampala, called on the Secretariat to intensify its efforts in promoting access to capital. The Heads of Government recognized the importance of improving the business and overall regulatory environment in reducing investor costs and promoting investment, and called for a greater focus on developing domestic financial markets and providing opportunities for domestic investors.

16. In responding to this call, the Secretariat proposes to:

1. **Build on the accomplishments of ongoing initiatives** – The Secretariat will continue to support the development of Commonwealth focused funds and

support existing funds to enter embryonic markets under CPII. The Secretariat is also proposing to undertake a developmental impact assessment of the second generation CPII funds to gain a clear understanding of the results the programme has delivered for member countries.

2. **Support the deepening of indigenous financial markets** – the Secretariat will launch financial sector diagnostics in selected countries. These will aim to provide an in-depth understanding of the financial sector focusing particularly on local currency denominated instruments, and identify gaps in the product mix (on both the investment and savings sides) that can be developed to help address the lack of long term local currency funding. The studies will also provide baseline data for the evaluation of the Secretariats' future work in this area. Financial literacy will also be a part of this, as will pilots such as the SME Credit information database and other initiatives.
3. **Build stronger partnerships** – with key stakeholders, especially regional and national institutions. The Secretariat already works in partnership with a number of institutions, including the Caribbean Development Bank and CARICOM. These partnerships can provide an effective means of leveraging resources for both parties. For the Secretariat, they are essential in ensuring that our work remains relevant to member countries.

17. The Secretariat is committed to continue to work across the whole membership, with a focus on developing country and small state members in Africa, South Asia, the Caribbean and the Pacific, recognising both the need to learn and spread lessons amongst the regions and that different regions may require different approaches.

18. In Africa, the Secretariat will continue to support for the SME Credit Information Database, which the Secretariat hopes to replicate in other regions. The Secretariat will also join the Partnership for Making Finance Work for Africa, a major initiative to support the efforts of African countries to accelerate economic growth and reduce poverty. The Partnership is based on the recognition that financial sector development can be a strategic driver of private investment, employment generation and economic growth. The Partnership aims at scaling up resources for the development of the financial sector in Africa and enhancing the sector's contribution to economic growth and poverty reduction. Through working with the partnership, the Secretariat hopes to leverage its' resources for greater impact and learn lessons / strategies which may be adapted for implementation in other regions.

19. The Secretariat proposes to launch financial sector diagnostic studies in the Caribbean and Pacific in the coming months. These studies will help to provide an understanding of the financial sector focusing particularly on local currency denominated instruments, and building on the leasing pilot in Trinidad and Tobago and Barbados. They will identify gaps in the product mix (on both the investment and savings sides) that can be developed to help address the lack of long term local currency funding. The studies will also provide baseline data for the evaluation of the Secretariats' future work in this area. On completion of the studies, the Secretariat will organise roundtables to explore the possibility of catalyzing partnerships similar to the Partnership for Africa in other regions.

20. The Secretariat's work will continue to work with CPII in all regions, pending the outcome of the development impact assessment. The focus will be on targeted support to enter selected Commonwealth countries where other funds are not active.

21. The work programme enables the Secretariat to better respond to member countries' needs by focussing on country and region specific challenges. It also allows the Secretariat to better target resources to regions and countries where other institutions are not active. This is key to the Secretariat's philosophy: adding value to the international system. Importantly, it plays to the Commonwealth's key strengths of a diverse membership and client base, which allows it to facilitate the transfer of knowledge and expertise across regions and its ability and willingness to undertake smaller programme interventions, including in small states.