

## OECD FORUM 2005

# FUELLING THE FUTURE: Security, Stability, Development

## Financing for Development

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### *“A Message from Asia: Ownership, Institutions and Markets”*

## 1. Introduction

Over the last twenty-five years, the Asian economies have achieved remarkable economic growth and persistent poverty reduction—despite the interruptions caused by the Asian financial crisis of 1997-98. They have achieved fundamental economic development—represented not only by increases in per capita incomes and shifts in economic structures but also by the societal transformations through advancement of human capacities, institutions and markets. The benefits of such economic development have been shared by the poor and have contributed to rapid improvements of social conditions, including health, sanitary conditions, and education. This success is the outcome of both the diligent efforts made by the Asians—as explained by the World Bank’s seminal work, “East Asian Miracle” (1993)—and their positive interactions with “good policies” pursued by developed countries. It is the combined outcome of developed and developing country policies, supported by effective ownership, institutions and markets on the part of the developing countries.

Similarly, meeting the Millennium Development Goals (MDGs) requires fundamental economic development on the part of low-income countries. Massive injection of official financial resources in 20 or so areas listed under eight goals might achieve most of the MDGs for the time being, but this may not be sustainable once such financial resource flows dry up. It is essential that each low-income country make substantial efforts to strengthen country ownership, improve institutions and nurture private sector-led markets to achieve sustainable, balanced economic development, thereby fulfilling the MDGs.

## 2. Surprising Facts behind the Paris Declaration on Aid Effectiveness

The international community has taken the view that while intensified efforts should be made to provide development assistance—including the increased flows as

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promised at Monterrey—aid effectiveness should also be significantly enhanced. Several key words have been: country ownership, donor-recipient partnership and donor coordination. From this perspective, the High-Level Forum on Harmonization in Rome (February 2003) adopted the “Rome Declaration” to harmonize and align aid delivery. To take far-reaching and monitorable actions to reform the ways aid is delivered and managed, the High-Level Forum on Aid Effectiveness in Paris (March 2005) has made several recommendations to be achieved by 2010. They are summarized in Table 1.

This table admits surprising facts. First, many aid recipient countries do not have national development programs, such as PRSPs, that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets. Second, many aid recipient countries do not have procurement or public financial management systems that either (a) adhere to broadly accepted practices or (b) have a reform program in place to achieve these. Third, many recipient countries do not report official aid flows on their national budgets. Essentially, many donors continue to direct official aid to recipient governments that do not have national development programs linked to budgets, that do not have broadly accepted procurement or public financial management systems of their own, and that do not report such aid on national budgets. This is scandalous.

The table reveals further annoying facts. Fourth, many donors provide aid to recipient countries without using the latter’s procurement and/or public financial management systems. Fifth, many official donors provide aid in parallel projects, i.e., with duplications. Sixth, many donors do not release aid on schedule even if the aid disbursements are to be made according to agreed schedules in annual or multi-year frameworks. Finally, many donors still keep their bilateral aid tied. Essentially, official donors, particularly when they provide small-scale grants, do not use the recipients’ procurement or public financial management systems, do not coordinate their aid efforts among themselves, do not maintain predictable aid flows, and do not provide untied aid. These facts are annoying because it has been repeatedly claimed that recipient country ownership, donor coordination and donor-recipient partnership are essential to improved “aid effectiveness.” This is the reason for the High-Level Forum to set some numerical targets to be achieved within certain time-frames.

***Recipient country ownership.*** There is no question that recipient countries need to develop their long-term development programs, with a time horizon of five to ten years, well beyond the horizon covered by typical PRSPs. Such national development programs need to clearly identify priority areas and sectors for rapid development—such as industrial and social infrastructure, education and health—which may be financed by foreign aid, which should be integrated with the national budgets. When a potential recipient county lacks the capacity to draft a national development program, to manage national expenditures or to establish a broadly accepted procurement or public financial management system, donors should step in to provide critical technical assistance so as to strengthen such fundamental capacities. Human resources in the recipient’s public sector need to be beefed up so that they acquire the capacities to draft their own national development programs, manage national and aid fiscal resources, and establish their own procurement/financial management systems that reflect international best practices

tailored to the specific country conditions. Donor-recipient joint work on a well-designed ODA project could provide an excellent opportunity to assist the recipient governments to develop their capacities at various layers of bureaucracy.

A recipient government should be in the driver's seat for the country's economic development and, in this sense, it is in the position to select "good" donors, i.e., donors who can truly contribute to the country's capacity and institution building and economic development. Dealing with too many donors, particularly with small-scale resources (typically less than US\$1 million), is often counterproductive for low-income countries in terms of administrative burden and costs. These costs are even higher if different donors require their own procurement and financial management systems rather than a single procedure. It would make the handling of aid more efficient if the recipient governments face a limited number of large-scale donors. These governments should legitimately decline small-amount donors if the cost of handling them exceed benefits—as India has done—or request them to combine their efforts by pooling their resources and policies. There are several ways of achieving this. First, small-scale official donors from the same donor country should coordinate their activities themselves. Second, small-scale donors working on a certain sector in a given low-income recipient country need to set up a common fund within an international organization and assist the country through such a fund. Third and alternatively, small-scale donors may be encouraged to channel aid through local NGOs in recipient countries. To some extent some of these are already happening, but true country ownership would suggest that the recipient countries have the right to say "no" to some donors whose handling cost is too high relative to the benefits.

### 3. Lessons from the East Asian Development Experience

East Asia's historic developmental experience reveals that three essential elements contributed to their successes:<sup>1</sup>

- Developing country efforts: industrialization based on markets and outward orientation with a focus on private sector-led investment and trade, supported by country ownership, effective institutions and bureaucratic capacities;
- Developed country efforts: maintenance of stable macroeconomic environments and an expanding, liberal trading system; and
- Effective development assistance.

***Industrialization through outward orientation and private sector-led growth supported by country ownership.*** The East Asian economies have adopted industrialization policies based on outward orientation and market incentives with emphasis on private sector-led investment and trade. They have focused on the role of private investment—in capital equipment, human resources, and market knowledge—and its nexus with trade as a basis for sustained economic development. Their

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1. Some of the first elements, but not all, have been analyzed by the World Bank (1993). This section draws on Kawai (2005b).

governments have made efforts to create a favorable investment climate, to reduce the risks and uncertainty of investment activity, and to ensure the availability of finance for productive investment opportunities. Many of them initially focused on import substitution and then shifted to export promotion in manufactured products. A major mechanism for export growth was through the expansion of domestic markets, which was achieved by the emergence of clusters of firms, supplier networks and distribution systems, which later became a basis for successful export expansion. Export expansion in turn helped each economy overcome the limits of the domestic markets and the foreign exchange constraints, and promoted learning, technology upgrading, and economies of scale. It was accompanied by liberalization of imports, foreign direct investment, and use of foreign technologies and ideas.

Such industrialization policies have been supported by strong country ownership, effective institutions and bureaucratic capacities. The East Asian states have had clear country ownership over long-term economic development programs and strategic views over the pace and extent of liberalization, deregulation and structural reforms. Many of them have developed five- or ten-year development plans on their own, which have focused on structural reforms for industrialization and urban development and on the need to reduce poverty and inequalities. More recently, they have emphasized the need to strengthen cross-border trust, confidence and links through regional cooperation—such as ASEAN and the Greater Mekong Sub-regional program. Rigorous implementation of policy and institutional reforms backed by country ownership has been an important driver of successful economic development.

***Developed countries’ “good policies” in macro, financial, trade and FDI.*** Favorable economic policies and conditions in developed countries—particularly in Japan, the United States and Europe—have positively affected prospects for growth, development and poverty reduction in developing East Asia through the impact on trade and capital flows.<sup>2</sup> First, these economies’ stable macroeconomic and financial conditions have greatly helped developing East Asian economies to benefit from trade and investment openness. Though volatile short-term capital flows interacted with weak domestic fundamentals and prompted the Asian financial crisis in 1997-98, the East Asian economies have been able to improve financial resilience since then.<sup>3</sup> Second, these developed countries’ liberal trade and investment regime and their increased provision of market access—through reductions of industrial tariffs and non-tariff barriers—to developing East Asia’s exports of labor-intensive manufactured products have encouraged the latter’s industrialization. The developed economies have indeed accepted industrial adjustment on their part by increasing imports, from East Asia, of those manufactured products which would be costly to produce domestically, by sending abroad the industries that had lost their comparative advantage, and by making the domestic labor markets flexible. Third, these developed countries’ steady supply of long-

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2. This is the issue related to “policy coherence” in the East Asian context. See Fukasaku, Kawai, Plummer and Trzeciak-Duval (2005).

3. It is important for developed countries to maintain stable macroeconomic and financial conditions to stem volatile capital flows vis-à-vis developing economies.

term risk capital—such as FDI—to developing East Asia has been crucial, because it has directly provided long-term funding, facilitated transfers of production technology, management know-hows and organizational skills, and enabled these firms to participate in the global and regional production chains and in the innovation process.<sup>4</sup>

**Effective ODA.** Developing East Asia has utilized external development assistance very effectively. The number of people living in extreme poverty—below \$1.05 per day at 1993 PPP—in East Asia declined substantially from 470 million in 1990 to 270 million in 2001 (Table 2). The amount of official development assistance (ODA) that East Asia received during this period totaled US\$113 billion, or less than US\$10 billion per year on the average (Table 3). This ODA performance in East Asia is outstanding—in achieving rapid economic growth and poverty reduction—in comparison to any other part of the developing world. For example, a total of US\$192 billion was disbursed as ODA in Sub-Saharan Africa during 1990-2001 but the number of poor rose (from 230 to 320 million) rather than declined.

The reason behind the successful ODA performance in East Asia is that it has been an effective catalyst in supporting broad, nationally owned development programs. These programs have focused on the need to promote market-based industrialization—particularly through overcoming unfavorable initial conditions, i.e., low levels of industrial and social infrastructure such as power, telecommunications, transport, water, health and education in recipient countries. ODA has contributed to the strengthening of such infrastructure to support private sector-driven, outward-oriented, pro-growth strategies.<sup>5</sup> First, ODA loans, provided by Japan, the World Bank and the ADB have ensured a certain degree of predictability in official resource flows for recipient countries. Second, the number of donors has been relatively limited so the recipients' administrative burden and costs of handling the donors have been a minimum. Third, the East Asian economies have had sufficiently high absorptive capacity in utilizing such ODA for these purposes. Finally, ODA donors in East Asia have also provided regional public goods—such as cross-border infrastructure—to those developing economies that are geographically connected. Its typical example is the Greater Mekong Sub-regional program which links several regional economies (Cambodia, Laos, Thailand and Vietnam) to stimulate cross-border trade, market access and poverty reduction. Essentially, ODA in East Asia has helped create a favorable investment climate and interacted positively with the recipient countries' political stability, stable macroeconomic policies, predictable business environments, and effective institutions.

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4. See Kawai (2005b) for the rising intensity of regional economic integration through market-driven trade, investment and financial flows.

5. From the donor perspective, ODA has three roles: provision of concessionary financing for building “hard” and “soft” infrastructure; policy advice for better governance and institutions; and capacity building for policy implementation. ODA donors in East Asia helped finance building industrial infrastructure and human resources, encouraged the recipient countries to strengthen their policy frameworks and institutional fundamentals through policy dialogue and consultation, and provided technical assistance in a wide variety of areas for capacity building.

#### 4. Capacities, Institutions and Markets

**Lessons for other developing countries.** There are three lessons to be learned for low-income countries elsewhere. First, domestic human and institutional capacities for development are essential to country ownership, without which sustained economic development is not possible. Second, trade and investment openness is key to success and low-income countries should not be afraid of globalization. Trade and investment with neighboring economies are particularly important and regional economic cooperation is pivotal to forge cross-border trust, confidence and links. Third, official aid can effectively support the development process if combined with recipient country ownership and efforts to improve domestic institutions, governance, human resource quality, and industrial and social infrastructure at the national and regional levels. What matters is not the amount of money to be injected in low-income economies, but how external aid helps the country's and the region's development process by building fundamental capacities and institutions for development. Only under such a condition, aid flows can be a catalyst of private sector-led trade and investment.

**Effectiveness of aid reconsidered.** As the East Asian experience demonstrates, official aid can have positive impact on the recipient country's economic development and poverty reduction if it provides basic industrial infrastructure, human capital development and institutional capacity building, thereby stimulating private investment, trade and FDI through. In sum, the effectiveness of official aid can be maximized under the following conditions:

- *Good policy environments in the recipient country.* Each recipient country must commit itself to sound macroeconomic, structural and social policies, good governance, and the rule of law. The resulting enabling environment would attract private capital, particularly foreign direct investment which complements official aid, and allow the recipient country to benefit from "good policies" pursued by developed countries.
- *Recipient country ownership of development.* Strong country ownership of its own development process is instrumental because without it policy and institutional reforms for economic development and poverty reduction cannot be implemented. The recipient country should have the right to select "good donors" who can contribute to its capacity building, governance improvement and economic development.
- *Donor coordination of assistance efforts.* The donor community needs to pursue harmonization of policies and procedures in order to reduce administrative and transactions costs, by focusing its assistance efforts on the strengthening of the recipients' capacities, institutions and governance. Small-scale donors should pool their resources and policies, preferably at an international organization that can utilize a common well-established procurement and financial management system, and can encourage the recipient to develop such a system domestically if it has not done so.
- *Donor-recipient partnership.* The donor community and a recipient country must work together in achieving the common goals of economic development and poverty reduction—including the MDGs—as the only objectives. This reflects the

past experience that aid-effectiveness is reduced when aid is tied to other often politically motivated objectives of donors.

## **5. Conclusion**

Many OECD member governments have expressed their good intentions to increase official aid to help achieve the MDGs. Following EU members and the United States, Japan has recently joined the group when Prime Minister Jun'ichiro Koizumi said at the Asia-Africa Conference in April 2005 that his government would double official aid to Africa in the next three years despite its fiscal problems. Let me conclude by saying that the MDGs can be achieved on a sustained basis only through fundamental economic development that requires coordinated efforts by developing and developed countries, with the developing countries in the driver's seat. The donor community needs to focus more on the provision of cross-border public goods to geographically connected developing countries so that they can lower transactions costs and increase access to markets, schools and hospitals—thereby contributing to poverty reduction and better education and health. Official aid can assist this process only if it becomes a catalyst of private investment and the recipients acquire adequate human and institutional capacities.

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