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"Overview: Miracle, Crisis and Beyond"*

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A Joint MOF/PRI-OECD Research Project:
The Impact and Coherence of OECD Country Policies on Asian Developing Economies

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Abstract

The East Asian development experience is still not well understood, especially in terms of the region's clustered catching-up growth and neighbouring effects among economies at different levels of industrial development. The development impact of OECD-country policies has never been analysed systematically in this context. A central question to be addressed here is how different policy vectors transmitted by OECD countries, notably in the areas of trade, investment and aid, may (or may not) have contributed to the development of the region. The intensity of such policy impacts may also depend critically on how East Asian economies have responded by means of public policy. This overview paper is intended to sketch out the main storylines of what has happened to East Asia over the past decades, and particularly since the mid-1980s, through the lens of 'policy coherence for development', and discuss key policy challenges both for East Asia economies and for OECD countries to help sustain the region's development process. An important challenge for the latter is to improve its peer review function with a view to enhancing accountability in economic policy-making for development.

I. Introduction

The East Asian development experience is still not well understood, especially in terms of the region's clustered catching-up growth and neighbouring effects among economies at different levels of industrial development. The development impact of OECD-country policies has never been analysed systematically in this context. A central question to be addressed here is how different policy vectors transmitted by OECD countries, notably in the areas of trade, investment and aid, have interacted on the development of the region. The intensity of such policy impacts may also depend critically on how East Asian economies have responded by means of public policy. This overview paper is intended to sketch out the main storylines of what has happened to East Asia over the past decades, and particularly since the mid-1980s, without getting into detailed discussions on individual country and policy developments which are the subjects of the papers commissioned for the project.

We begin by explaining the background against which this joint research project has been launched and why it has been decided to take a regional approach with a focus on East Asia. We then seek to highlight the main features of the development experience of this region through the lens of 'policy coherence for development' and discuss key policy challenges both for East Asia and for OECD countries to help sustain the region's development process.

Why Policy Coherence for Development?

While attempts at reforms necessary to achieve development goals should be home-grown, international initiatives can provide significant support, and in some cases may define the political feasibility of such reforms. The United Nations Declaration of the Millennium Development Goals in September 2000 has prompted the international community to step up its effort to build a global partnership for development. This led to the launching at Doha in November 2001 of a new trade round under the auspices of the WTO, followed in 2002 by the Monterrey Consensus on Financing for Development in March and the World Summit on Sustainable Development in Johannesburg in September. A key to success in these endeavours is to seek "greater coherence in global economic policy-making" (Paragraph 5 of the Doha Ministerial Declaration) in which OECD countries have an important stake.

Within this internationally shared perspective, the OECD 2002 Ministerial Meeting issued a statement on development, calling upon the OECD to "*enhance understanding of the development* *dimensions of Member country policies and their impact on developing countries*". The OECD has responded to this ministerial mandate by launching a horizontal programme on policy coherence for development.[1] The term 'policy coherence' generally refers to the consistency between objectives and instruments applied by individual OECD countries on the one hand, and the consistency among objectives, on the other, in the light of their combined effects on developing countries. In other words, the problem of policy *in*coherence for development arises when the objective of policy undertaken in a particular field for development is undermined or obstructed by actions of government in other policy fields. Work envisaged in the OECD horizontal programme seeks to identify such a mismatch in a specific policy context and suggest alternative actions to ensure that OECD countries' policies help promote or at least do not harm the economic interests of developing countries.

Furthermore, the OECD work on this topic seeks to facilitate and support efforts of both OECD and developing countries to encourage the systematic promotion of mutually-reinforcing policy actions, including aid but extending beyond it.[2] Indeed, the notion of policy coherence, as defined in this way, may provide a useful framework for rethinking the co-operation of OECD Member countries with non-member (developing and transition) economies (see Box 1.1). More than three and a half decades ago, in his seminal work entitled *Economic Policies Towards Less Developed Countries*, Harry Johnson (1967) stated that:

> "the expansion of aid should be integrated with the expansion of trade opportunities, and that the two together should be used to provide the maximum inducements to the less developed countries to modify the policies of currency overvaluation and import substitution to which they are addicted and to concentrate their efforts instead on economic development through trade with the rest of the world (p.245)."

Since then, as will be discussed in the next section, several East Asian developing economies have displayed remarkable catching-up records based on outward-oriented growth strategies, as advocated by Harry Johnson and many others. In addition, a growing number of developing economies in other regions have undertaken policy reforms to liberalise foreign trade and exchange-rate regimes, albeit to varying degrees, and attract foreign direct investment, thereby integrating their economies more closely into the world economy. As a consequence, the economic linkages between OECD and developing

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[1] See the OECDwebsite: http://www.oecd.org/development/policycoherence.

[2] The OECD Policy Brief on "*Policy Coherence: Vital for Global Development*" (July 2003) highlights the types of issues at stake and identifies the potential for seeking greater coherence between official development assistance (ODA) and other policies. These include, *inter alia*, such issues as agriculture, trade policy, investment, knowledge transfer, migration and global resources.

countries have undergone some remarkable changes and will continue to evolve in the coming years (OECD 1995 and 1997). This requires OECD Member countries to formulate their economic policies in such a way as to properly reflect the changing economic relations vis-à-vis non member countries.

[Insert Box 1.1 here.]

Why Focus on East Asia?

Given the background described above, this project takes a regional approach, with special reference to East Asia's development experiences in the post-war years, and especially since the mid-1980s. In the first place, the East Asia region is of particular interest from the standpoint of the impacts of OECD countries' policies. The links between the region's developing and transition economies and major OECD countries are strong not only through the international exchange of goods and services but also in terms of international flows of capital, technology and labour. As we will discuss in the next section, a number of developing economies in this region have sustained high economic growth by historical standards for a significantly long period. The development experience of several high-performing East Asian economies in the 1970s and 80s is often referred to as the "East Asian miracle" after the publication of a World Bank report in 1993 and has stirred policy debates among academic researchers and policy makers over the past decade. After all, the East Asia's development experience has shown the world that growth, poverty reduction and even "graduation" [3] are possible in the developing world, provided one embraces the correct policies in an enabling international economic environment.

Perhaps more surprisingly, most of these "miracle" economies have strongly rebounded from the financial and currency crises that badly hit the region in 1997-1998. Nonetheless, they face several new challenges that are closely related to the often-heard question: Is East Asia's catching-up growth sustainable? In this conjunction, it is important to emphasize that the East Asia region still includes several least-developed and low-income countries, with a significant number of the world's poorest people. Thus, it remains a big challenge for these governments and people to sustain and even repeat the "miracle" performance during the coming decades. Indeed, one of the main objectives of this joint project is to draw major development lessons, based on the actual experiences of more advanced developing economies of East Asia, for low-income countries in the region as well as for many developing countries in other regions.

[3] Two countries in the region have acceded to the OECD membership (Japan in 1964, and Korea in 1996).

The rest of this paper is organised as follows. Section II revisits the region's 'miracle' performance and highlights major policy developments underlying the region's catching-up growth. Section III reviews the causes and effects of the 1997-98 economic crisis and discusses the post-crisis development prospects of the region. Section IV seeks to recapture development lessons from East Asia and discuss key policy challenges for OECD countries.

Box 1.1 - Towards Greater Coherence in Development Policy-Making

The issue of policy coherence for development is hardly new. It can go back to the mid-1960s (Johnson 1967). Yet, it has become increasingly important since the mid-1980s, as closer linkages with OECD countries through trade, investment and technology flows have been recognised as crucial factors in the success of developing countries to sustain growth and catching-up processes.

Langhammer (1995, p.213) states an interesting view regarding the role of OECD countries for development: "Developing countries stand to gain if OECD countries fully exploit their growth potential to act as engines, refrain from protectionist measures, provide stable money, export private risk capital and aid to net borrowers, and create fresh human capital that cascades down to lower-income countries and thus keeps world-wide structural change moving". According to this view, a top priority for OECD countries is to 'keep their own house in order' by maintaining macroeconomic health, providing private and public funds for investment and increasing structural flexibility in their own economies.

Seen from the developing-country perspective, the lack of coherence in development co-operation may arise when there is a serious mismatch between the objectives of OECD countries' different policies and their effects on development. For instance, OECD countries are providing financial resources to developing countries in the form of ODA, the benefits of which might be offset by the adverse effects of their actions in other policy areas, such as trade. Examples are numerous at bilateral, regional and global levels.* James Michel (1997), a former DAC Chair, states that it is increasingly evident that a comprehensive approach employing coherent policies across a range of government activities is essential, and yet officials in aid agencies and trade ministries (for example) often act independently of one another as if aid and trade were independent or even competing policy instruments. As a matter of fact, the DAC regularly conducts a peer review of its member countries' aid policies, which now involves discussions on policy coherence. But much closer co-operation between the DAC and other relevant OECD Committees is needed, if the member countries wish to give more weight to this review process.

Seeking greater coherence in development co-operation has become even more important in the case of the European Union; Article 130v of Title XVII of the Masstricht Treaty** is often referred to as 'coherence article' in the field of development co-operation (Hoebink 1999). Furthermore, Sweden has become the first nation in the world to pass into law an integrated global development policy (IDRC Press Release, 28/1/2004). The country's agriculture, environment, migration, trade and other policies must now, by law, align to fight poverty and promote sustainable development. The Government must report to Parliament on implementation.

Finally, the issue of policy coherence for development has an international dimension as well: in the absence of a world government, the rich countries are primarily responsible for providing international public goods (Kindleberger 1986), such as an open and stable international marketplace upon which the economic welfare of all countries depends. Some OECD countries now consider that stricter trade rules and obligations should be applied to several more advanced developing countries, as they join the ranks of 'major players' on world markets.

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* See, for example, Grilli (1993) for the European Community, and Krueger (1993) for the United States. In a more general context, there is a large body of literature on "North-South" economic linkages, including, among others, Fukasaku *et al*. eds. (1995), OECD (1995 and 1997) and Forster and Stokke eds. (1999).

** Article 178 of the Amsterdam Treaty as from 1 May 1999.

II. Revisiting East Asia's "Miracle" Performance

One of the defining characteristics of world development during the second half of the 20th century is the emergence of East Asia as the third growth pole of the world economy (Table 1.1).[4] The region's real GDP grew at an average annual rate of 5.8 % during the last five decades. As a result, the share of East Asia in world GDP amounted to 27 % in 2001, up from 11 % in 1950. On the other hand, the population of East Asia remained roughly the same in relative terms as what it was five decades ago: the region's combined population was a little over 2 billion at the beginning of the new millennium, which is equivalent to one third of world population. Measured on a per-capita basis, the growth performance of East Asia has been the most prominent among major regions. In 1950 the average level of the region's per capita GDP was estimated at $ 685 (at 1990 international prices), which was lower than the corresponding figure for Africa ($ 894). Five decades later, it had risen more than seven times to surpass $ 5,000 by the turn of the century. Furthermore, the region's rapid economic growth has been accompanied, with few exceptions, by significant reductions in absolute poverty and noticeable improvements in social indicators, such as life expectancy, infant mortality and literacy (see Annex Tables 1-4).

[Insert Table 1.1 here.]

The development experience of East Asia throughout much of the post-war years is such that a number of economies in the region have managed in a sequential fashion to achieve historically high growth rates of per-capita GDP – typically 4 to 6 % per annum or even higher in some cases - for a significantly long period (Table 1.2). Starting from Japan in the 1950s and 60s, the region's growth dynamism has continued apace since the 1970s, with the ascendancy of so-called 'Four Tigers' (Chinese Taipei, Hong Kong, Korea and Singapore), followed by several 'newly industrializing economies' (NIEs) of Southeast Asia (Indonesia, Malaysia, Thailand and most recently, Vietnam) and China. Though less spectacular, India's growth performance over the last decade has also come closer to that level.

[Insert Table 1.2 here.]

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[4] The long-term statistical database on population and GDP (at 1990 international dollars) used for this chapter is available on-line from Maddsion (2003). In this chapter "East Asia" is defined geographically as a region covering both North- and South-east Asia: it stretches out from the Korean peninsula to Myanmar and from Mongolia to Indonesia. Note that Angus Maddison defines "East Asia" differently: his definition covers not only North- and South-east Asia both also the Indian subcontinent and Afghanistan.

These East Asian economies are highly diverse in terms of population size, natural resource abundance, initial income level and relative factor endowment, as well as political and social systems, religion and culture. Despite such high diversity, East Asia's economic success through much of the post-war years has been remarkable by historical standards (Maddison 1995 and 2001). Furthermore, the apparent success in adjustment and growth in several Asian NIEs during the turbulent period of the 1970s and 80s has drawn considerable attention of academic and development policy communities to the question of what was the exact policy mix that might have enabled them to achieve superior performances. [5]

The 1993 report published by the World Bank represents one of the first major attempts to explain what caused the success of East Asian economies (see Box 1.2). The report focused on the growth performance and domestic policy developments in the first eight economies listed in Table 1.2 (excluding China but including Indonesia). In a nutshell, it argued that the rapid growth in *each* economy was primarily due to the application of a set of common, market-friendly policies ("getting the fundamentals right"), which led to both higher accumulation and also better allocation of resources. It also stressed the importance of creating and securing a pro-business environment that led to very high levels of private sector-led growth. The authors of this report admitted, however, that there was much to be studied about the role of selective intervention by governments in their attempts to hasten growth. Nonetheless, their view was that the institutional context within which intervention policies are implemented is as important to their success or failure as the policies themselves.

To be sure, the report has stimulated debate among academic researchers and policy makers regarding the role of government for development in general and the interaction between policy choices and institutional capability in particular. While there is now a large body of literature, rethinking the growth strategies and experiences of East Asia and other regions still continues. [6]

[Insert Box 1.2 here.]

East Asia's Multi-layered Catching-up Process

East Asia's success in achieving high per-capita growth rates during the period concerned is primarily a result of successful industrialisation. It has been argued that this is a sequential industrialisation,

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5 See, among early contributors, Amsden (1989), Wade (1990) and Young (1992 and 1995).

6 See, for example, Amsden (2001), Stiglitz and Yusuf, eds. (2001), Subramanian and Roy (2001), Van Arkadie and Mallon (2003) and Rodrik (2003).

starting from labour-intensive sectors with small capital requirements, and moving up to capital-intensive sectors, such as heavy and petrochemical industries, and then to technology-intensive sectors, like machinery and electronic industries. Such a sequence of industrial development with shifts in leading industries in an economy during a particular period of time is often called the "flying-geese pattern" (Akamatsu 1961 and Yamazawa 1990). In the context of East Asia, Ito (2001) presents some supporting evidence, which shows a fall in the share of labour-intensive sectors in total value added and a corresponding rise in the share of technology-intensive sectors in several East Asian economies.[7] While it is true that the "flying-geese" metaphor captures the regional patterns of industrial development quite nicely, it does not necessarily tell us what made such *clustered* growth possible.

Based on the historical data provided by Maddison (2003), Figure 1.1 traces the real per-capita GDP ratios relative to the United States for 9 East Asian economies over the period of 1950-2001. It displays several interesting features regarding East Asia's multi-layered catching-up process:

- While Japan's super-growth performance came to an end in the early 1970s, the region's two city-states, Hong Kong and Singapore, managed to achieve high growth records in the 1970s and again in the second half of 80s and early 90s. But their growth momentum appears to have been substantially weakened in the aftermath of the East Asian crisis.
- Chinese Taipei and Korea were the region's best growth performers throughout the entire post-war period (Table 1.2). Their catching-up growth even accelerated in the post-1973 period, which is in a sharp contrast with the case of Japan. It is also worth noting that despite the 1997-98 crises which hit the region very badly, Korea has managed to achieve a V-shape recovery (see the next section for further discussions).
- The catching-up growth of three natural resource-rich countries (Indonesia, Malaysia and Thailand) also began in the early 1970s and accelerated from the mid-1980s, as their manufactured exports became an engine of growth. Yet, this growth process was (temporarily) halted by the outbreak of financial and currency crises in 1997-98.
- China had lifted growth rates substantially in the 1980s, owing to the country's "Reform and Opening-up" that began in late 1978. Subsequently, the country has emerged as the best

[7] Labour-intensive sectors (ISIC 311-332) are defined to include food, beverage, tobacco, textile, apparel, leather products, shoes, lumber and furniture, while technology-intensive sectors (ISIC 382-390) involve general, electronic, transport and precision machinery and equipment. The relative share of capital-intensive sectors (ISIC Code 341-381, including paper, printing and publishing, petrochemicals, rubber, plastic, non-metal minerals, steel and non-ferrous metal) in total value added expanded first and then declined, as income rose to high levels.

growth performer over the past decade. The catching-up process has not been arrested by the East Asian crisis.

[Insert Figure 1.1 here.]

It is clear from the above brief observation that these East Asian developing economies (except China) simultaneously experienced major economic turnarounds in the early 1970s and again in the mid-1980s. As Hsiao and Hsiao (2003) point out, it would be implausible to consider such a coincidence either as random or as a deliberate co-ordinated act on the part of their governments.[8] This was not so much due to the consequence of any particular domestic economic policy but due to significant changes in international economic environment. Indeed, the 1970s saw sea changes in the international economic system, with the emergence of strong inflationary expectations in major OECD countries, a breakdown in the Bretton Woods fixed-exchange rate system and the first OPEC oil shock. In retrospect, adjustment to these developments led to the end of a "golden age of unparalleled prosperity" for Western economies (Maddison 1995). As far as Japan is concerned, the economy had already reached the post-war peak after the so-called "era of rapid economic growth" in the 1960s. Meanwhile, the country had also moved from a labour-surplus to a labour-shortage economy. A significant tightening of labour market conditions, together with a successive round of the yen's real appreciation and the second oil shock in the early 1980s, propelled Japanese firms to invest abroad in, and import more goods from, other East Asian economies. This adjustment process further continued apace in the wake of the so-called Plaza Accord of the dollar-yen currency realignment that took place in September 1985.

The 1970s were also the beginning of what is now called 'microelectronics revolution'. This has helped both revitalise mature industries through the development of labour- and energy-saving technologies (e.g. numerically-controlled machine tool, robotics, compact cars) and develop electronic, computer and other high-tech industries. One of the major consequences of these technological and industrial developments is the growing importance of intra-product specialisation in manufactured trade. While trade in parts and components (as opposed to end products) is hardly new, its share in total trade has risen significantly in East Asia (*reference*). If the stages of a production process are physically separable, the manufacture of a product is amenable to fragmentation so that the various stages of production can be spatially separated and undertaken at different locations where the costs of production are lowest. Although

[8] Hsiao and Hsiao (2003) present an interesting analysis of comparative economic developments of Chinese Taipei and Korea covering both pre-war and post-war periods. But, East Asia's multi-layered catching-up process during the post-war period also involves other developing economies of the region, as Figure 1.1 shows.

spatial dispersion of production processes across countries usually entails the costs of communication and co-ordination as well as other trade costs due to restrictive trade policies and practices, recent advances in telecommunication and transportation technologies and reductions in trade and investment barriers have substantially reduced the trade costs and thus stimulated fragmentation of production processes across national borders (Arndt and Kierzkowski 2001). This new development of international division of labour has facilitated East Asian economies' entry into the network of international production sharing and establishment as viable competitors in the world markets. The economic ascendancy of four Asian Tigers during the 1970s can be seen as the harbinger of a promising growth model.

Perhaps, most of the literature on the East Asia's development experience has given too much focus to the question of how domestic policies and institutions in individual economies were growth-generating and paid too little attention to the question of how growth stimuli and incentives were generated and transmitted from more advanced to less advanced economies in a particular region. As Ozawa (2003, p.710) states, the effectiveness of growth-promoting policies at the individual economy's level depends critically on how each economy can respond to and exploit the external environment and opportunities by means of public policies. In this respect, the effectiveness of growth-promoting policies may be pretty much context-specific (Rodrik 2003). These points are especially pertinent for us to have a better understanding of how East Asia's multi-layered catching-up process has been working over the past two decades.

In discussing East Asia's multi-layered catching-up process, some brief comments may be in order with respect to the influence of geography and security.[9] As regards geography, such as climate, inherited health and access to markets, there is wide recognition that the development experience of a particular country or a region are in no small part influenced by both natural and human geography.[10] For instance, those countries that find themselves in the tropical zone (mostly developing countries) may have adverse growth prospects than those located in the temperate zone for various reasons. These reasons include, among others, the long-lasting, negative impact of tropical diseases on education and health and thus on labour productivity; the dominance of extractive industries in national economy and its potentially negative consequence for public institutions and governance; and a low quality of soil and plant diseases that may lead to low productivity in agriculture. A recent study by Gallup *et al*. (2003) examines the influence of

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[9] We owe much to Richard Carey and Paul Isenman who brought up these issues at the preparatory meeting in November 2003 and at the Mid-Term Review Meeting in April 2004.

[10] Note that the influence of geography on development has historical and cultural dimensions as well. Countries tend to interact closely with their neighbours both in history (alas, often in wars and conflicts) and through cultural exchanges, which has an important ramification for development.

geography on per-capita GDP growth by estimating standard growth equations augmented by including additional explanatory variables representing both natural and human geography. Their results do lend support to the view that health conditions related to geography may be a major obstacle to long-term growth; other things being equal, countries at high risk of malaria tend to grow slower than countries free from malaria by 0.6 percentage points, which is large relative to other explanatory variables. Perhaps most relevant in the current context is their finding that geography can explain only a small fraction of the growth gap observed between Latin America and East Asia. Moreover, geographical factors tend to make East Asia grow slightly *less* than Latin America (p.65). This would imply that good infrastructure, adequate policies and well-functioning institutions can help developing countries overcome many of obstacles imposed by geography.

Security is another important issue that has a direct bearing on the development of East Asian economies in the post-war years. In the context of the East-West rivalry, maintaining regional security on which domestic political stability critically rests is of the foremost importance to those economies having strategic alliances with the Western block. That is why the Association of Southeast Asian Nations (ASEAN) was created in 1967 to deal mainly with the political fear originating from instability in Indochina and in mainland China at that time. Subsequently ASEAN countries made joint efforts to promote intra-regional trade and economic co-operation among themselves in the second half of the 1970s and early 1980s through the establishment of ASEAN Preferential Trade Arrangement in 1977 and various region-wide industrial development schemes.[11] However, these early attempts achieved little in the economic arena, as the scope of regional economic co-operation was very limited at that time and the import-substitution bias was still strong in many of the member states. Later on, the Asia-Pacific Economic Co-operation (APEC) was created in 1989 as the first broad intergovernmental forum aiming at closer economic co-operation and partnership, involving both developed and developing countries across the Pacific.[12] However, the APEC forum started without a clear mandate and was seen in the post-Cold War context "as a means to maintain political stability in Asia where destabilising elements still exist" (Urata 1998, p.39). Therefore, while domestic political stability underpinned by the US-led, security arrangements laid a critical foundation for the development of the region, major policy initiatives to promote growth and poverty reduction were undertaken at the individual country level. As we will discuss below, several East

[11] These programmes include, among others, the ASEAN Industrial Project (1976), the ASEAN Industrial Complementation Scheme (1981) and the ASEAN Industrial Joint Venture Scheme (1983).

[12] The 12 original members of APEC are six ASEAN countries (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand), five OECD countries (Australia, Canada, Japan, New Zealand and United States) and Korea (which became an OECD Member in 1996). The current 21 member economies of APEC include Chile, China, Chinese Taipei, Hong Kong-China, Mexico, Papua New Guinea, Peru, Russia and Viet Nam, in addition to the original 12.

Asian economies have been able to participate in globalisation through a process of industrial restructuring which exploits close inter-linkages between trade and FDI.

East Asia's Trade-FDI Nexus

It should be noted at the outset that opinions regarding the role of FDI for development were highly divergent in the 1970s. While the degree of divergence appears to have narrowed considerably over the past three decades, this question still remains politically sensitive for certain developing and transition economies. This is because FDI is "not only owned and controlled by private groups in pursuit of private profits but also by private interests that are non-resident to boot"(Reuber *et al.*, 1973, p.16). Much of the FDI flowing into many developing countries has been attracted by the availability of natural resources. What has been observed in East Asia since the mid-1980s is a rapid rise in a new type of FDI, such as export-oriented, manufacturing FDI. Many developing economies of the region have significantly, and in some cases (such as China) dramatically, altered their attitudes and policies concerning FDI. This alteration is closely linked to a significant shift in growth strategies: FDI can play an important role in the development of new export bases in host economies, the restructuring of home economies, the direction of trade flows, the transfer of technology and knowledge and hence the growing interdependence of national and regional economies . Among the developing areas the East Asia region has been a highly attractive location for FDI, though foreign investors have increasingly taken a differentiated approach between countries within the region.

While trade and FDI flows are closely linked through the procurement and sales activities of multinational enterprises (MNEs), the net impact of FDI can be either trade-creating or trade-replacing. In fact, the relationship between trade and FDI flows is very complex at both macroeconomic and firm levels.[13] Nonetheless, FDI flows in East Asia tend to be more trade-creating than trade-replacing, because of the region's growing emphasis on export-oriented manufacturing production. For instance, a study by Kawai and Urata (1995) on Japanese manufacturing FDI in East Asia finds that there exists a strong complementary relationship between Japan's FDI and its exports in many sectors (for example, food, textiles, chemical products, general machinery and electrical machinery), while at the same time, promoting reverse imports from the region.

The positive effect of trade and FDI on growth is one of the most critical factors underlying the strong growth performance of the East Asian economies, though the relationship between openness (to

[13] See, for example, Katseli (1997), JBIC (2002, Chapter IV) and OECD (2002b, Chapter IV) for further discussions.

international trade and investment) and growth has been a subject of intensive discussions among academic researchers (Box 1.3). Petri (1995) argues that the emergence of a ‘trade-FDI nexus’ is a key feature of East Asia’s outward-oriented growth. Liberalisation of trade and investment policy regimes unilaterally undertaken by many economies in the region has improved the policy environment, favouring the expansion of both trade and FDI flows. Conversely, strong trade and FDI performance has encouraged governments to sustain outward-oriented trade and investment policies, thereby integrating their economies more closely into the international market. Such a positive relationship between liberalisation initiatives and strong trade and FDI growth seems to have worked in East Asia’s favour during the period concerned.

[Insert Box 1.3 here.]

Table 1.3 presents major trends in inward and outward FDI stock as a percentage of GDP in selected East Asian economies during the past two decades. The role of FDI for East Asia’s catching-up growth has been quite diverse among the economies of the region; some have relied more on FDI than others. For those economies, such as Hong Kong, Singapore, Malaysia and more recently, China and three new members of ASEAN (Cambodia, Lao, PDR and Viet Nam), FDI inflows have become increasingly important for their economies. This is in sharp contrast with the experience of Japan, Korea and Chinese Taipei in the 1970s and 80s, as these economies relied much less on ‘FDI as a package’ and more on licensing arrangements as a means of importing foreign technology. It is only quite recently (particularly, after the 1997-98 crisis) that the FDI stock-GDP ratio has started to rise markedly in Chinese Taipei and Korea, as these economies have eased restrictions or taken measures to encourage FDI inflows.[14]

[Insert Table 1.3 here.]

Table 1.3 also displays that not only Japan but also more advanced developing economies, especially the four Asian NIEs, have emerged as direct investors from the region, as their economies are climbing up ‘technological ladders’ in industrial development and relocating labour-intensive segments of production to less advanced developing economies. China has benefited enormously from this multiple catching-up process since the mid-1980s (see Box 1.4). More recently, it appears that the similar forces are at work in driving the Vietnamese economy (Van Arkadie and Mallon 2003), and to a lesser extent, other parts of Indochina.

[14] Note that Japan’s FDI stock-GDP ratio more than doubled between 1995 and 2002, though starting from a very low level.

From the perspective of low-income countries and especially the least-developed ones, more analytical work is required to address the question of how the dynamic process of a trade-FDI nexus can be sustained in the less developed part of East Asia and may be replicated in other developing regions. One important line of work in this context is the role of export–processing zones (EPZs) and other special zones as a transitional policy. A recent work by Schrank (2001) highlights contrasting experiences in the development of EPZs between the Dominican Republic on the one hand and Korea and Mexico on the other. This study provides an important reminder that the success of EPZs depends not so much on the attitudes and capacities of foreign investors but on those of *local* manufacturers. Furthermore, Subramanian and Roy (2001) attribute the success of EPZs in Mauritius to the quality of domestic institutions in managing rent–seeking and inefficiency involved in selective intervention. These studies point more generally to the question of building productive and institutional capacity in developing countries, and in particular least–developed ones. This is a topic that has gathered increased attention since the late 1990s and particularly in the context of post–Doha development challenges.[15]

Multilateral versus Regional Approaches

Multilateral trade liberalisation under the auspices of the GATT/WTO can be regarded as an institutional foundation underlying East Asia's multi-layered catching-up process. It can be argued that a gradual opening of OECD markets through the eight rounds of multilateral trade negotiations is a *sine qua non* of the region's clustered growth based on outward-oriented industrialisation (Table 1.4). Perhaps, one of the most successful episodes to date is that of China. The country embarked on the so–called "Reform and Opening–up" in late 1978 and moved to embrace the coastal development strategy in the mid–1980s in order to promote trade and attract FDI. Indeed, China's reform process was closely related to long and often painstaking accession negotiations at the GATT/WTO, which began in 1986 (Fukasaku and Solignac Lecomte, 1998).

[Insert Table 1.4 here.]

Until quite recently, East Asian economies have taken a route different from other regions in order to accelerate trade liberalisation at a regional level. The Asia Pacific Economic Co-operation (APEC) forum was launched in 1989 as a brainchild of Bob Hawke, then Australian Prime Minister, who coined

[15] See the OECD Policy Brief on "*Trade Capacity Building: Critical for Development*" (August 2003) for further discussion.

the term “open regionalism”. The APEC stands out as a unique case of regional integration and co–operation agreements, based on two pillars. One is to undertake non–discriminatory confidence–building measures, such as enhanced exchange of macroeconomic information, increased transparency of trade policies among member economies, trade and investment facilitation, consultation, voluntary codes and networking. The other is to design and implement voluntary but common liberalisation programmes. At the Bogor Meeting in 1994, the APEC Economic Leaders announced their intention to pursue “free trade and investment” in the region by 2010 (for developed economies) or 2020 (for the rest), according to this principle, in other words, *concerted* unilateral liberalisation.

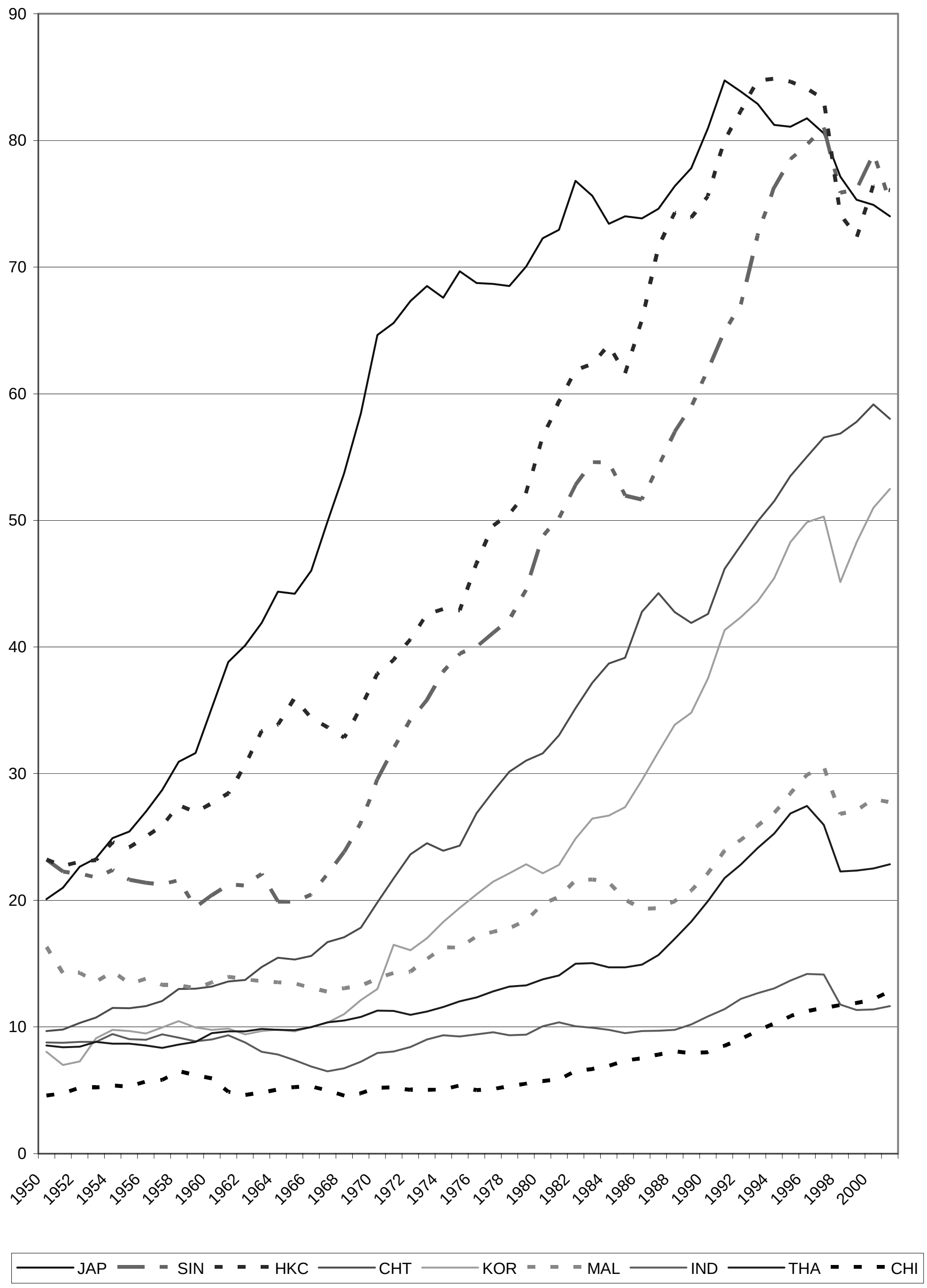
Among the habitual incentives for trade negotiations between and among countries, the APEC route towards free trade and investment among member economies is indeed a novel approach. However, if traditional political economy is a guide, it would not be realistic to expect concerted unilateral liberalisation to succeed beyond marginal measures, because of the free–riding problem under voluntarism and the non–binding nature of policy commitments (Pelkmans and Fukasaku, 1995).

More recently, East Asia has begun to embrace FTAs as a way to accelerate market opening within the region, given the difficulties that the WTO has encountered in trying to promote freer trade on a global scale (Urata 2004). Table 1.5 presents a list of the FTAs (involving East Asian economies) that are already in action, concluded, under negotiation or under study. Such an FTA bandwagon may have reflected a fundamental change in the attitude of many East Asian governments towards regional integration and co-operation. As many of the region’s economies are recovering from the 1997-98 crises, external pressures such as FTAs would be considered necessary to deepen structural reforms in pursuit of regaining and sustaining growth momentum. Furthermore, the East Asian economies have taken FTAs as part and parcel of so-called New Economic Partnership Agreements which include, *inter alia*, trade and FDI facilitation and economic assistance. How this new policy development may contribute to greater coherence of trade, FDI and aid policies remains to be seen.[16]

[Insert Table 1.5 here.]

[16] How regionalism may or may not contribute to development has been under intensive discussion. See, for example, Kreinin and Plummer (2002) for a critical review of this topic.

Figure 1.1 - Real Per-Capita GDP for 9 East Asian Economies Relative to United States, 1950-2001



Box 1.2 - The East Asian Miracle: What the World Bank's 1993 Report Tells Us

In a nutshell, this report tells us that most of East Asia's rapid growth is due to higher accumulation of physical and human capital, better allocation of resources to more productive investments and the capability to use, acquire and master technology. It also shows that there is no single "East Asian model" of development, as these eight economies applied different and changing sets of policies to achieve rapid growth and poverty reduction. The diversity of economic policies ranged from hands off to highly interventionist, depending upon individual country cases and particular periods of time. Despite that, the report concludes that the "East Asian Miracle" was based on six key policy fundamentals (pp.347-352):

(1) Ensuring low inflation and competitive exchange rates (to support outward-oriented growth);
(2) Building human capital (which is critical to rapid growth with equity);
(3) Creating effective and secure financial systems (to encourage financial savings and channel them into high productive investments) ;
(4) Limiting price distortions (so as to draw resources into labour-intensive production in early stages of development, shifting to capital- and knowledge-intensive activities in later stages);
(5) Absorbing foreign technology (through licensing and/or foreign direct investment); and
(6) Limiting the bias against agriculture (which is key to reducing rural-urban income differentials in East Asia).

At the same time this report also highlights the importance of creating institutions (e.g., a merit-based bureaucracy and public-private consultative bodies) to implement policies once adopted and to establish a market-friendly environment that is conducive to private investment. On the other hand, it is sceptical about the effectiveness of government intervention in promoting specific industries or industrial sub-sectors and concerned about the high costs involved in the use of directed credit, even if this may have worked in certain situations.

The eventful experience of the 1990s and research work conducted over the past decade have led to a series of reappraisals and counter-reappraisals regarding the determinants of growth in East Asia, the role of public policy and formal and informal institutional arrangements, including another World Bank study (Yusuf, 2001). While it is not clear at this stage whether sectorally-targeted industrial policies had positive, negative or little impact on long-term growth in East Asia, this does not mean that the government can not do much other than macroeconomic management in promoting and sustaining economic growth. Indeed, the experience of East Asian economies suggests that their governments have played a significant role in many areas of particular importance to sustained growth, including health and education, infrastructure development, and technology transfer and capability building (Noland and Pack 2003).

Box 1.3 - Openness and Growth

Openness to trade and FDI can potentially bring many benefits to liberalising economies. First, imports are an important source of new ideas, new goods and new services that are essential to improve productivity and sustain growth (Romer, 1993 and 1994). Import liberalisation also stimulates domestic competition and can act as a catalyst for greater efficiency and innovation. Second, exports are crucial to financing imports essential for development. In addition to this obvious role, exports of manufactures and non–traditional goods and services provide a useful yardstick against which policy makers can design and implement the most effective policy mix (World Bank, 1993). Third, FDI augments capital stock, stimulates inflows of technology and know–how from more advanced countries and enhances competition in domestic markets. Although much of FDI flows into developing countries in the 1960s and 1970s were oriented towards natural resource extraction, FDI flows in manufacturing and service sectors have become increasingly important since the 1980s. In order to attract FDI on a sustained basis, host governments must provide favourable investment climate by ensuring stable macroeconomic conditions and reduce the degree of product market distortions in their economies (Hiemenz *et al.* 1991).

The positive relationship between openness and growth appears to be fairly robust (see, among others, Dollar, 1992; Sachs and Warner, 1995; Frankel and Romer, 1999; Dollar and Kraay, 2001, and Baldwin 2003), though it is difficult to establish the causation in a rigorous manner. Three points are worth noting in this respect. First, several conventional measures of "openness" (i.e. trade–GDP ratio, tariff rates, the extent of non–tariff barriers, and the degree of distortions in foreign exchange markets) frequently applied to the cross–country regression analysis has been criticised, because they do not necessarily reflect the impact of trade policy *per se*. They may well capture the impact of good institutions and government policy in general (Pritchett, 1996 and Rodriguez and Rodrik, 1999). Second, the transmission mechanisms through which freer trade may cause higher growth in liberalising economies are not well specified in these cross–country studies. Some argue that it is import liberalisation, rather than export expansion, that may have a stronger impact on productivity and growth (Clerides et al., 1998, and Lawrence and Weinstein, 2001). Or the causation might run in the opposite direction: higher productivity in manufacturing industries leads to higher exports (Bradford, 1994). Third, empirical analysis needs to take into account more explicitly the trade–FDI–growth dynamics in liberalising economies (Urata, 2001). In this respect, Démurger (2000) makes a useful contribution to the understanding of the dynamics in the Chinese context by investigating the effects of opening up to foreign capital on the country's growth and on the evolution of inter–provincial disparities over the last two decades. It also demonstrates an added value of the country–specific approach to empirical research on openness and growth.

Box 1.4 - Trade-FDI Nexus: the Chinese Style

The degree of outward orientation differs widely from country to country and period to period. While it is not easy to tell precisely how China's trade and FDI regimes have evolved over time in terms of actual policy orientation and the degree of protection, it is safe to say that it was in the mid-1980s that the Chinese authorities sent clear signals both at home and abroad that they were intending to establish a trade regime in favour of export production. This period corresponds to China's *de facto* adoption of the coastal development strategy, an active encouragement of FDI flows through various schemes of preferential treatment and the beginning of successive real effective devaluation of the Chinese currency (Fukasaku and Wall 1994).

Perhaps the most dramatic turnaround brought about by the process of "Reform and Opening-up" was the shift away from prohibition on FDI inflows towards its active encouragement. Given that the economy has a high rate of domestic savings, the primary purpose of this regime change was to gain access to modern technology, both embodied and disembodied, packaged with capital, management skills and international business networking. A key aspect of China's policy reform with respect to FDI is to enact politically crucial but unspecific 'enabling laws' first, which allows the government to introduce more specific policy measures later, when political and economic conditions are met. The first measure taken after 1978 was the landmark 1979 Joint-Venture Law, which was followed by numerous laws and regulations in various areas of direct relevance to both Chinese and foreign firms, including income tax, profit repatriation, labour management, land use, property rights and so on. The country's current FDI policies are well documented in OECD (2002c, pp.330-337).

With respect to FDI, the Chinese authorities use the term 'foreign-invested' or 'foreign-funded' enterprises, which are of three types: equity joint ventures, contractual (or co-operative) ventures and wholly foreign-owned ventures. As the table below shows, foreign-invested firms (FIEs) have rapidly become major exporters. Despite their fast export growth, the trade performance of FIEs has resulted in net trade deficits in most years until quite recently. The major turnaround came in December 1996 when the *Renminbi* became convertible on current account. This policy change has "not only assisted China's international traders but also greatly facilitated the business operations of foreign investors in China" (OECD 2002c, p.328).

Box Table - Trade Performance of Foreign-Invested Enterprises in China

Year	Value of FIEs Trade ($ Billion) Total Trade	Exports	Imports	FIEs Relative to China's Total (Percentages) Total Trade	Exports	Imports	($ Billion) Trade Balance of FIEs
1985	2.4	0.3	2.1	3.4	1.1	4.9	-1.8
1990	20.1	7.8	12.3	17.4	12.6	23.1	-4.5
1995	109.8	46.9	62.9	39.1	31.5	47.7	-16.0
1996	137.1	61.5	75.6	47.3	40.7	54.4	-14.1
1997	152.6	74.9	77.7	47.0	41.0	54.6	-2.8
1998	157.7	81.0	76.7	48.7	44.1	54.7	4.3
1999	174.5	88.6	85.9	48.4	45.5	51.8	2.7

Source: OECD (2002c), Table 10.2, p.327.

FDI inflows into China's manufacturing sector have been heavily concentrated in so-called 'labour-intensive' industries. This does not necessarily mean that this type of FDI is a poor source of transferable, useful technology and know-how that might contribute to the enhancement of China's industrial efficiency. Quite to the contrary, a recent study based on a firm survey of Hong Kong garment sector investing in China finds that Hong Kong-based FIEs act as en effective channel of transferring advanced, market-focused managerial know-how and practices to mainland China (Thompson, 2003).

Table 1.1 - The Performance of Major Regions, 1950-2001

Major Regions	Population (Million) 1950	2001	GDP (Billion 1990 $) 1950	2001	GDP per Head (1990 $) 1950	2001
Western Europe (29)	305	392	1,396	7,550	4,579	19,256
Western Offshoots (4) [a]	176	340	1,635	9,156	9,268	26,943
of which United States	152	285	1,456	7,966	9,561	27,948
Eastern Europe (7)	88	121	185	729	2,111	6,027
Former USSR (15)	180	290	510	1,343	2,841	4,626
Asia (57)	1,382	3,654	984	14,106	712	3,861
of which East Asia (16)	850	2,029	582	10,222	685	5,038
Japan	84	127	161	2,625	1,921	20,683
China	547	1,275	240	4,570	439	3,583
Others [b]	220	627	181	3,028	825	4,831
South Asia (5)	461	1,346	286	2,499	621	1,857
India	359	1,024	222	2,003	619	1,957
Others [c]	102	322	64	496	629	1,539
West Asia (15)	60	241	106	1,343	1,776	5,580
Africa (57)	227	821	203	1,223	894	1,489
Latin America (47)	166	531	416	3,087	2,506	5,811
World (216)	2,524	6,149	5,330	37,194	2,111	6,049
	Percentages				Relative to US (100)	
Western Europe (29)	12	6	26	20	48	69
Western Offshoots (4) [a]	7	6	31	25	97	96
of which United States	6	5	27	21	100	100
Eastern Europe (7)	3	2	3	2	22	22
Former USSR (15)	7	5	10	4	30	17
Asia (57)	55	59	18	38	7	14
of which East Asia (16)	34	33	11	27	7	18
Japan	3	2	3	7	20	74
China	22	21	5	12	5	13
Others [b]	9	10	3	8	9	17
South Asia (5)	18	22	5	7	6	7
India	14	17	4	5	6	7
Others [c]	4	5	1	1	7	6
West Asia (15)	2	4	2	4	19	20
Africa (57)	9	13	4	3	9	5
Latin America (47)	7	9	8	8	26	21
World (216)	100	100	100	100	22	22

Notes:
a. Australia, Canada, New Zealand and United States; b. Excluding Japan and China; c. Excluding India.
(   ) figures in brackets indicate the number of countries/economies.
Source: Calculated by the author based from Maddison (2003).

Table 1.2 - The Growth Performance of 16 East Asian Economies, 1950-2001

	Per Capita GDP (1990 $)									
	Absolute Levels			Growth Rates [a]						
	(A)	(B)	(B)/ (A)							
Economies	1950	2001		50-60	60-70	70-80	80-85	85-90	90-95	95-01
Hong Kong	2,218	21,259	10	3.5	6.2	6.3	4.0	6.6	3.4	0.4
Singapore	2,219	21,011	9	0.4	6.8	7.4	3.5	5.9	6.0	1.5
Japan	1,921	20,683	11	7.6	9.3	3.3	2.7	4.2	1.1	0.7
Chinese Taipei	924	16,214	18	4.9	7.2	7.0	6.7	4.0	5.8	3.6
Korea, Rep.	770	14,673	19	3.7	5.9	7.7	6.6	8.9	6.3	3.7
Malaysia	1,559	7,756	5	-0.2	3.1	5.8	2.6	4.3	6.3	1.8
Thailand	817	6,383	8	2.8	4.6	4.2	3.6	8.7	7.3	-0.5
China	439	3,583	8	4.4	1.5	3.1	7.4	4.1	7.4	5.1
Indonesia	840	3,256	4	2.0	1.6	4.6	1.1	5.0	5.9	-0.5
Philippines	1,070	2,412	2	3.3	1.8	3.0	-3.6	2.3	0.0	1.4
Vietnam	658	1,850	3	2.0	-0.8	0.3	4.2	2.2	6.2	4.8
Myanmar *	396	1,408	4	3.6	1.3	2.5	2.9	-3.3	4.9	5.6
Lao, PDR	613	1,204	2	1.0	1.0	1.6	1.0	0.2	3.0	1.8
Korea, Dem. Rep.	770	1,154	1	3.7	5.9	3.8	0.0	0.0	-11.8	-4.5
Cambodia	518	1,124	2	3.4	-0.5	2.4	2.5	-2.0	1.8	2.4
Mongolia	435	1,070	2	3.0	3.0	3.0	3.9	0.8	-4.5	0.2
East Asia (16) Average	685	5,038	7	4.7	4.7	3.4	3.9	4.1	4.3	2.6
NIEs-4 [b]	955	16,013	17	4.0	6.3	7.3	6.1	6.9	5.8	3.2
ASEAN-4 [c]	911	3,856	4	2.2	2.4	4.3	0.9	5.4	5.4	-0.1
CLMV [d]	544	1,626	3	2.6	0.0	1.3	3.5	0.1	5.4	4.8

Notes: a. Annual average compound growth rates calculated by the author; b. Chinese Taipei, Hong Kong (China), Korea and Singapore; c. Indonesia, Malaysia, Philippines and Thailand; d. Cambodia, Lao PDR, Myanmar and Vietnam; * Myanmar's population and GDP figures require further investigation. Source: See Table 1.1.

Table 1.3 – Inward and Outward FDI Stock as Percentage of GDP in Selected East Asian Economies, 1980 - 2002

		1980	1985	1990	1995	2000	2002
Hong Kong							
	Inward	623.8	525.5	269.6	163.4	280.2	265.7
	Outward	0.5	6.7	15.9	56.6	238.9	227.2
Singapore							
	Inward	52.9	73.6	83.1	78.7	124.0	137.5
	Outward	31.7	24.8	21.3	42.0	58.1	79.1
Malaysia							
	Inward	20.7	23.3	23.4	32.3	58.6	59.4
	Outward	0.8	4.3	6.1	12.5	20.8	21.2
Viet Nam							
	Inward	0.2	1.1	4.0	28.5	48.2	50.2
	Outward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Cambodia							
	Inward	2.4	2.0	3.4	12.1	39.9	41.0
	Outward	n.a.	n.a.	n.a.	0.1	0.1	0.1
China							
	Inward	3.1	3.4	7.0	19.6	32.3	36.2
	Outward	n.a.	-	0.7	2.3	2.4	2.9
Lao, PDR							
	Inward	0.3	-	1.5	11.6	32.1	33.4
	Outward	n.a.	n.a.	n.a.	-	9.9	12.8
Indonesia							
	Inward	13.2	28.2	34.0	25.0	40.4	32.2
	Outward	n.a.	0.1	0.1	0.6	1.6	1.5
Thailand							
	Inward	3.0	5.1	9.6	10.4	20.3	23.9
	Outward	-	-	0.5	1.3	2.0	2.1
Philippines							
	Inward	3.9	8.5	7.4	8.2	12.2	15.0
	Outward	0.5	0.6	0.3	1.6	2.1	1.8
Chinese Taipei							
	Inward	5.8	4.7	6.1	5.9	9.0	11.9
	Outward	0.2	0.3	8.0	9.5	15.9	21.2
Korea							
	Inward	2.1	2.3	2.1	1.9	8.0	9.2
	Outward	0.2	0.5	0.9	1.6	11.0	9.1
Japan							
	Inward	0.3	0.3	0.3	0.6	1.1	1.5
	Outward	1.8	3.2	6.6	4.5	5.8	8.3

"- ": negligible.
Source: UNCTAD, *World Investment Report 2003* (Annex Table B.6).

Table 1.4 – GATT/WTO Trade Negotiations 1947-2004

Year/Period	Place/Name	Subjects Covered	Participation
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-1961	Geneva (Dillon Round)	Tariffs	26
1964-1967	Geneva (Kennedy Round)	Tariffs, anti-dumping measures.	62
1973-1979	Geneva (Tokyo Round)	Tariffs, non-tariff measures, "framework" agreements.	102
1986-1994	Geneva (Uruguay Round)	Tariffs, non-tariff measures, rules, agriculture, services, textiles, intellectual property, dispute settlements, creation of WTO, etc.	123
2002-2004 (planned)	Geneva (Doha Development Agenda)	Tariffs, non-tariff measures, rules, agriculture, services, special & differential treatment, etc.	147

Source: Based on WTO (1998, p.9).

Table 1.5 – Free Trade Agreements and East Asian Economies (as of April 2004)

In Action	Under Negotiation	Under Consultation/Study
Bangkok Treaty (1976)	China-ASEAN	China-New Zealand
ASEAN FTA(1992)	Chinese Taipei-Panama (concluded)	Japan-Australia
Laos-Thailand (1991)	Hong Kong-New Zealand	Japan-ASEAN
Singapore-New Zealand (2001)	Japan-Mexico (concluded)	Japan-Indonesia
Japan-Singapore (2002)	Japan-Korea	Japan-China-Korea
Singapore-Australia (2003)	Japan-Thailand	Korea-Australia
Singapore-EFTA (2003)	Japan-Philippines	Korea-ASEAN
Singapore-US (2004)	Japan-Malaysia	Korea-Mexico
China-Hong Kong (2004)	Korea-Chile (concluded)	Korea-New Zealand
China-Macao (2004)	Singapore-Canada	Korea-Singapore
	Singapore-Mexico	Singapore-P3 (Aus, Chile, NZ)
	Thailand-Australia	Singapore-Chinese Taipei
	Thailand-Bahrain (concluded)	Thailand-Peru
	Thailand-India (concluded)	ASEAN-CER (Aus, NZ)
	Thailand-US	ASEAN-EU
		ASEAN-India
		ASEAN-US

Note: This table has been compiled on the basis of Urata (2004) and updated according to WTO and other official sources.

III. East Asian Crisis and Beyond

The rapid growth of several East Asian economies since the mid-1980s, attracted by their financial opening and exchange rate pegs, led to a large inflow of private capital in the early 1990s.[17] Fuelled by such capital inflows, private credit booms created pre-crisis vulnerabilities in the region. To be sure, a greater availability of international private funds is a 'good thing' for development, since this is potentially welfare-increasing in recipient countries. However, greater financial integration makes their economies more vulnerable to a sudden change in the investors' sentiment and external economic environment, such as international interest-rate shocks. The experience of several East Asian economies in the early 1990s suggests that difficulties in managing large capital inflows was increasingly recognised as a critical policy issue for macroeconomic management at that time, as these economies were running near or at a full capacity (IMF 1995). Indeed, heavy capital inflows became disruptive for countries such as Thailand, as they led to a real appreciation of the currency, heightened inflationary pressures through increased money supply and widened the country's current-count deficits to an 'unsustainable' level.[18] Table 1.6 shows major trends in total capital inflows in Developing Asia, five crisis countries and China for 1994-2002.[19] While the predominant type of net capital inflows in China has been direct investment, the five crisis countries had become increasingly dependent on portfolio investment and other (short-term) capital to finance ever-increasing investment demand prior to the crisis. Domestic financial systems tended to prove too weak as a conduit for heavy capital inflows, resulting in over-borrowing and declining credit quality, thereby increasing financial fragility (Reisen 1999).

[Insert Table 1.6 here.]

Echoing these analyses, World Bank (1998) summarises the major causes of the 1997-98 crisis by pointing the finger at three common forces that interacted each other to leave these economies vulnerable to external shocks: (1) ready availability of private capital, especially short-term capital; (2) macroeconomic and exchange-rate policies that permitted capital inflows to fuel a credit boom; (3) newly

[17] It has been argued that falling U.S. interests rates in the early 1990s was an important 'push' factor in driving private capital to emerging economies (Ferdandez-Arias and Motiel, 1996).

[18] In Thailand, for example, the current account deficit in 1996 amounted to -7.9 % of GDP (Table 1.6). What size of current account deficit is "sustainable" is difficult to determine *a priori*, and depends crucially on the perception of investors which may be influenced by the country's stage of development, the level of government deficit, the way funds are spent and so on.

[19] See Annex Table 1.5 for disaggregated data for individual five countries.

liberalised but insufficiently regulated financial systems.[20] While the Thai stock market had already declined substantially during the first half of 1997, a trigger to the crisis came when the government yielded to the repeated attacks against the baht and abandoned the peg on 2 July. The financial and currency crisis of Thailand developed into a region-wide crisis, as contagion spread to Indonesia, Korea and other economies of the region by causing a sudden huge outflow of capital and a simultaneous fall in asset prices. The economic consequence of the 1997-98 crisis was a heavy blow to the economies of the region in terms of the fiscal cost of bailing out and reconstructing the financial sector (Table 1.7) and the output foregone due to the worst recession that ensued (Table 1.8). Moreover, there was some concern that the social impact of the crisis may have a lasting effect on the economy over the longer term (Box 1.5). Such concern has brought greater attention to the question of social cohesion and domestic governance in the East Asian society.

[Insert Box 1.5 here.]

[Insert Table 1.7 here.]

[Insert Table 1.8 here.]

Social Cohesion and Domestic Governance

The 1997-98 crises have made one thing clear to every citizen in East Asia: informal, family-based mechanisms on which traditional societies relied as the main form of social protection was not able to cope with such nation-wide shocks that brought down a great number of households simultaneously. This bitter experience has underscored an urgent need to establish more formal mechanisms for managing risk and protecting the poor and vulnerable in society. All five crisis countries have been trying to adapt existing institutions to evolving social conditions and establishing new ones during and after the crisis.

Annex Table 1.6 summarises information available on four major areas of social protection (social assistance, social insurance, employment and community-based schemes) in five East Asian countries. Given the complexity of policy developments, this table should be seen only as an illustrative list of key programmes put in place in these countries. It is important to note at the outset that the shape of individual

[20] There is now a large body of literature on the causes of the East Asian crisis. Interested readers should see, among others, Montes (1998), Radelet, S. and J. Sachs (1998), Woo, Sachs and Schwab (2000).

country’s social protection regime has been greatly influenced by cultural and value patterns as well as policy developments in the past years.

A case in point is that of Malaysia, where there was no unemployment insurance or benefit that provides a safety net for displaced workers at the time of the crisis. Provision of social assistance in the form of cash transfers was also targeted only to particular vulnerable groups. On the other hand, the country has instituted since 1951 a compulsory saving scheme, called the Employees’ Provident Fund, with a view to providing uniform retirement and other benefits for roughly two thirds of total employees (excluding agricultural workers and casual employees). Similarly, Korea attached high value to the importance of work incentives: provision of social assistance was conditional upon the acceptance of vocational training and community-based jobs – the programme called “social integration through work (SIW)”. By contrast, sales of subsidised rice and public work programmes constituted two central pillars of social protection in Indonesia and the Philippines during the crisis. This is presumably because the incidence of poor households is widespread, especially in remote rural areas. In the case of Thailand, a wide range of social insurance, welfare and assistance programmes was decentralised to the community level.

Meanwhile, a number of proposals have been put forward to improve the design and implementation of policies. First, under-coverage has been recognised as a serious drawback to East Asia’s social protection regimes. Workers in the informal sector as well as those in the rural area constitute the majority of the workforce that are the most vulnerable and are often excluded from public social services. Second, the design and choice of targeting mechanisms require further study, taking into account individual countries’ particular situations: trade-offs are evident in terms of economic incentives, fiscal objectives and political acceptability. Third, involvement of civil society organisations (CSOs) in programme implementation and monitoring is essential to enhance the efficiency and coverage of social protection policy. The question remains about how best to establish a good working partnership between the government and CSOs.

More generally, there is the case for thinking or rethinking the basic approach to the sustainability of East Asia’s economic growth and development by going beyond the ‘policy patchworks’. This is because two longer-term policy challenges that are common to many East Asian economies deserve much more serious attention in the coming years. One is a demographic challenge to the health of public finance as a consequence of a rapidly ageing society, and the other a globalisation challenge to cope with issues related to greater labour mobility across borders, technological capability development and trans-border environmental spillovers. The East Asian society would need to take a forward-looking approach to meet these new challenges in a more coherent manner.

Strengthening Governance Structure on International Finance and Investment

The successive financial and currency crises of the 1990s have led to the realisation that these crises resulted not only from specific (and often idiosyncratic) factors in particular countries, but also from some common problems inherent in today's international financial system. The risks involved in large flows and sudden reversal of short-term capital are now widely recognised. It is therefore, necessary but not sufficient for individual host economies to put their own financial houses in order, so as to reap the benefits of financial globalisation without falling victim to its own risks. Hence, some reforms are required at both global and regional levels.

Active discussions on policy initiatives regarding how to strengthen international financial architecture began soon after the Mexican peso crisis in December 1994 (Kenen 2001). The East Asian crises of 1997-98 gave a further impetus to this process and its agenda setting. In this context, Kiichi Miyazawa, then Finance Minister of Japan, delivered an important speech in Tokyo in December 1998 by addressing three most critical issues arising from recent crisis experiences. These are: (1) how to cope with large-scale, short-term capital movements, (2) how to determine an appropriate exchange rate regime, and (3) how to provide liquidity to crisis countries (Miyazawa 1998).

In the following year, on the occasion of G7 Summit Meeting in Cologne in June, the Report of G7 Finance Ministers made a six-point, comprehensive set of recommendations, with the view to promoting global financial stability through appropriate national actions and enhanced international co-operation.[21] These recommendations are:

1. Strengthening and reforming the international financial institutions (notably, the IMF) and arrangements;
2. Enhancing transparency and promoting best practices (in various areas, including disclosure of financial data, transparency in fiscal and monetary policies, corporate governance and so on);
3. Strengthening financial regulation in industrial countries (particularly with regard to the operation of highly leveraged institutions and offshore financial centres);

[21] Before the Cologne Summit, the new Financial Stability Forum was created in April to enhance international co-operation and co-ordination in the area of financial market supervision and surveillance (see http:/www.fsforum.org).

4. Strengthening macroeconomic policies and financial systems in emerging economies
5. Improving crisis prevention and management, and involving the private sector;
6. Promoting social policies to protect the poor and most vulnerable.

As regards point 4, it was recognised that "capital account liberalisation should be carried out in a careful and well-sequenced manner, accompanied by a sound and well-regulated financial sector and by a consistent macroeconomic policy framework (para 30, sub-para 4)". Moreover, the Final Statement of the Cologne Summit decided to support the Financial Action Task Force on money laundering as well as the work of OECD's Forum on harmful tax competition and the actual start of implementing the guidelines and recommendations adopted by the OECD with respect to the harmful effects of unfair tax practices. These works were carried out and endorsed at the two successive meetings of G7 Finance Ministers in Fukuoka (2000) and Rome (2001).

Meanwhile, efforts to promote monetary and financial co-operation in East Asia have been directed to three particular areas: enhancing the information exchange and surveillance process, improving the resource provision mechanism, and nurturing the Asian bond market. As for the first area, the Manila Framework Group was established in November 1997. The Group meets semi-annually and brings together deputies from the finance ministries and central banks of 14 countries within and outside the region, together with the ADB, IMF and World Bank. Furthermore, the ASEAN+3 (China, Japan and Korea) surveillance process was established in November 1999 and the first peer review meeting was held in May 2000 in the sidelines of ADB's Annual Meeting. As regards the second area of regional co-operation, the Chiang Mai Initiative was launched at the ADB Annual Meeting in the following year. One of the main objectives of this initiative called for an expanded ASEAN Swap Arrangement and a network of bilateral swap and repurchase agreement facilities among ASEAN+3 countries (Rana 2002).[22] More recently, greater attention has been paid to the third area: the development of deeper and more liquid local currency bond markets, which can facilitate a more efficient allocation of the large pool of domestic savings within the region.

Finally, it is also important to note that the relationship between opening access to international capital markets and economic growth, particularly issues related to the timing and sequencing of capital account liberalisation, has come to the fore as a topic of intensive discussion in the Report of G7 Finance

[22] The total number of bilateral swap agreements has increased to 16 and the total size of these arrangements to US$ 36.5 billion (see the Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting held in Jedu, Korea on 15 May 2004.

Ministers in Rome (para 23-31). At the same time, the Report emphasises the contribution of FDI to economic growth, and argues that the lack of a proper investment environment, due to weak governance as well as political and economic uncertainty, is one of the major obstacles to attracting FDI in developing countries. In this context, the Report calls for the need for establishing a stable and non-discriminatory investment regime at the multilateral level, which serves to enhance the predictability and stability of investment regimes in support of liberalisation and sustainable development (Box 1.6).

Beyond the Crisis

We end this section by raising the following question: "In retrospect, what was the East Asian Crisis, when viewed from the perspective of the region's catching-up process?" Was it a temporary blip in the long-term growth trend or something more fundamental?

Ito (2001) offers an interesting view that once financial sectors are free of the past problem of non-performing loans and supervision is enhanced, the real sector will provide as strong a push as it did in the past. Arguably this view fits nicely with the post-crisis recoveries that have occurred in most of the crisis countries and notably in Korea.[23] In a similar vein, Verbiest (2003) argues that "the Asian tiger story we know is only the beginning of a story: the Asian tigers will not change their stripes, and their stripes will become even bolder". His upbeat view is based on the fact that over the past years East Asian economies as a whole have demonstrated the remarkable resilience to multiple shocks, such as the bursting of the high-tech bubble and a recession in major OECD countries, high and volatile oil prices, jitters of terrorism and the Iraq War and the SARS epidemic. Moreover, new growth dynamics are at work in the region, including the ascendancy of two very large tigers, China and India and the emergence of new cubs, such as Viet Nam, the rapid growth in intra-regional trade and a progressive coming of age of the Asian consumers.

Is there any downside risk to the future of East Asia's clustered growth? There are at least three major concerns. First of all, it is important to design necessary domestic policies and institutions so as to ensure that the benefits of economic growth should be more broadly and equitably shared within the society. Although many East Asian economies have been successful in alleviating extreme poverty over the past decades, it has proven to be more difficult to reduce *relative* poverty. What policy lessons can be

[23] It is interesting to recall in this conjunction that both Chinese Taipei and China managed to escape from the currency contagion after the fall in Thai baht in July 1997, due largely to the closed nature of their capital accounts.

drawn from the experience of more advanced developing economies of the region (e.g., Chinese Taipei and Korea) in this respect?

A second major concern is about the countries that have been 'left behind' or less successful in participating in the region's multi-layered catching-up process. The Philippines are a case in point. Several low-income countries of the region should also benefit from greater participation in the catching-up process. It would be more urgent now to get these countries out of poverty in a progressive manner for the sake of domestic political stability and regional security. Is the creation of a region-wide FTA the way we should go? How should aid policy be adapted to this challenge?

In this regard, an important policy question for low-income ASEAN countries is how ODA programmes can be more directly linked to FDI through their emphasis on promoting infrastructure development. One of the key lessons emerging from the experience of East Asia's catching-up growth is that Japan and other advanced East Asian economies have regarded outward FDI in the less advanced economies of the region as part of industrial restructuring necessary to move up technological ladders and to shift domestic resources to more efficient uses. It is critically important to keep this dynamic process moving.

Third, FDI flows into the ASEAN countries have slowed down in recent years relative to those into China. ASEAN countries are now facing the major challenge of improving their attractiveness as a location of FDI in a rapidly changing economic environment. A recent study by McKibbin and Woo (2004) regarding the global economic impact of China's accession to the WTO suggests the possibility of de-industrialisation in ASEAN-4 economies, if these economies allow the drop in FDI inflows to reduce the rate of technological diffusion to their economies. They argue that ASEAN-4 economies must "give the highest priority in deepening and widening their pool of human capital by speeding up the diffusion of new knowledge to their scientists and managers and providing appropriate retraining programmes for the displaced workers (*Ibid*., p.7)". In a more general context, Yusuf (2003) also argues that East Asian economies will have to move on to a technological- rather than a factor-intensive mode of production if they wish to maintain the current growth momentum in the future.

Box 1.5 – Social Impact of the Crisis

There are basically four *direct* channels through which the crisis has affected negatively the well-being of individual households. First, a sharp contraction in production reduces the demand for labour, which results in a reduction in real wage rates and/or an increase in unemployment. Second, a bout of high inflation during the crisis and its aftermath dents real household expenditure. For example, the annual rate of consumer price inflation in Indonesia shot up from 6.2 per cent in 1997 to 58.5 per cent in 1998 and stayed over 20 per cent in 1999. Third, higher import prices as a result of real currency devaluation reduce the purchasing power of household income. Fourth, a substantial loss of property incomes (dividends, capital gains and rents) reduces total household income. In addition, the welfare of poor households will further deteriorate *indirectly* through the government's lower spending on education, health care and other social services as a consequence of economic downturns. Such direct and indirect effects of the crisis are difficult to measure empirically, because hard figures are often lacking.

Despite these difficulties, national authorities in the crisis countries and multilateral financial institutions have attempted to assess the nature and extent of the social impact of the crisis.* Having reviewed the results of some earlier assessments, Booth (1999) concludes that the initial fear over the immediate impact of the crisis in the form of mass poverty and destitution was an exaggeration, though poverty incidence increased substantially in all crisis-hit countries but more dramatically in some countries than others. She also points out that the increase in the head-count incidence of poverty was due largely to the effects of a high rate of inflation in Indonesia, while a surge in open unemployment was the main factor behind the increase in poverty in Korea, Malaysia and Thailand.

Annex Table 1.2 suggests that East Asian countries have made great strides in alleviating *extreme* poverty (as indicated by the lower international poverty line) over the last ten years or so. The crisis has arrested and reversed temporarily such overall trend. However, the decline of *relative* poverty (as indicated by the upper international poverty line) has been much slower than that of extreme poverty. Three years after the crisis, the proportion of the 'near-poor' stays at very high levels in Indonesia (around 60 per cent) and the Philippines (45 per cent), followed by Thailand (30 per cent).

Evidence thus far indicates that the social impact of the crisis was substantial, and more importantly, the impact on poverty was much more severe in some countries than others. One reason is that workers displaced from the formal industrial sector were absorbed in agricultural and (informal) service employment. In other words, much of the adjustment took the form of lower real wages. In the case of Malaysia, it has been pointed out that migrant workers bore the brunt of the adjustment burden more than domestic ones (World Bank 2000, p.117). Another reason was that as in the case of Thailand, agricultural exports have received a positive boost from real currency devaluation, which has contributed to supporting rural household income.

Finally, the indicators at hand can not fully capture the social consequences of the crisis, because the poverty phenomena are dynamic in nature. For example, a large number of households that fell below the poverty line during the crisis may have moved up to the non-poor status later on. Such cases of 'transient poverty' are not well understood. More importantly, the financial damage incurred on poor households (e.g., lost educational opportunities) may be irreversible, affecting their children negatively over their life spans.

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* See, among others, Knowles *et.al*. (1999), Booth (1999) and Wold Bank (1998, 2000) as well as country case studies in contained in OECD (2002a).

Box 1.6 - International Investment Instruments

Although there are no universal rules governing international investment, OECD Member countries are committed to providing non-discriminatory treatment to inward direct investment and related financial flows by virtue of the legally binding *OECD Codes of Liberalisation*. The 35 countries* that adhere to the *OECD Declaration on International Investment and Multinational Enterprises* have also undertaken a political commitment to accord national treatment to established foreign direct investors, to promote voluntary standards of corporate responsibility by multinational enterprises, to encourage restraint in the use of investment incentives and to avoid the imposition of conflicting regulatory requirements on multinational enterprises. These instruments have provided an effective framework for international co-operation and have served to underpin the liberalisation achieved in recent decades.

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* All 30 OECD Member countries plus Argentina, Brazil, Chile, Estonia and Lithuania. The OECD encourages non-members to adhere to this Declaration, which includes the *Guidelines for Multinational Enterprises*.

Table 1.6 – Net Capital Inflows in Developing Asia ($ Billion)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Developing Asia[1]									
Total capital flows, net	94.9	152.5	176.5	7.0	-86.6	-46.4	-34.0	-9.9	-16.5
Direct investment, net	52.0	64.8	72.2	80.4	74.9	74.7	59.7	61.6	52.0
Portfolio investment, net	19.1	24.4	34.1	14.3	2.7	32.5	11.3	-64.4	-61.2
Other capital flows, net	23.8	63.3	70.2	-87.7	-164.2	-153.6	-104.9	-7.0	-7.2
Memorandum items									
ODA, net	15.4	14.2	12.1	10.1	12.3	12.9	11.7	11.8	n.a.
Changes in reserves[2]	-59.7	-50.7	-69.2	5.5	-67.5	-87.2	-61.6	-77.1	-131.4
Current Account	-27.0	-64.6	-78.4	-1.2	140.3	142.4	113.9	98.1	135.9
Crisis countries[3]									
Total capital flows, net	33.3	62.5	74.9	-13.1	-33.5	-12.5	-15.8	-12.1	-7.1
Direct investment, net	6.4	8.4	11.1	12.4	11.8	12.4	6.3	2.7	2.6
Portfolio investment, net	11.2	20.6	28.7	16.6	-3.4	13.1	7.2	6.2	0.0
Other capital flows, net	15.7	33.5	35.2	-42.1	-41.9	-38.0	-29.4	-21.0	-9.7
Memorandum items									
ODA, net	3.2	3.3	2.2	1.8	2.8	4.0	3.0	2.4	n.a.
Changes in reserves[2]	-8.5	-14.9	-14.6	33.4	-46.4	-39.5	-26.0	-9.0	-23.2
Current account	-22.2	-39.1	-53.8	-26.4	69.8	62.5	44.3	30.0	33.0
China									
Total capital flows, net	32.6	38.7	40.0	21.0	-6.3	5.2	2.0	34.8	32.3
Direct investment, net	31.8	33.8	38.1	41.7	41.1	37.0	37.5	37.4	46.8
Portfolio investment, net	3.5	0.8	1.7	6.9	-3.7	-11.2	-4.0	-19.4	-10.3
Other capital flows, net	-2.7	4.0	0.2	-27.6	-43.7	-20.5	-31.5	16.9	-4.1
Memorandum items									
ODA, net	3.2	3.5	2.6	2.1	2.4	2.4	1.7	1.5	n.a.
Changes in reserves[2]	-30.5	-22.5	-31.7	-35.9	-6.2	-8.7	-10.7	-47.4	-75.2
Current account	6.9	1.6	7.2	37.0	31.5	21.1	20.5	17.4	35.4

Notes:
1. 24 economies in Asia and the Pacific, including Korea and Singapore (but excluding Chinese Taipei).
2. A minus sign indicates an increase.
3. Indonesia, Korea, Malaysia, the Philippines, and Thailand.
Sources: IMF, International Financial Statistics (CD-ROM) and OECD/DAC, International Development Statistics.

Table 1.7 - The Fiscal Impact of Banking and Currency Crises in the 1990s

Country	Years	Non-performing Loans (percentage of total loans at peak)	Fiscal and Quasi-fiscal Costs * (Percentage of GDP)	Public revenues (Percentage of GDP)
Finland	1991-93	9	8 -10	33
Norway	1991-93	9	4	40
Sweden	1991-93	11	4 - 5	39
Mexico	1994-95	11	12 -15	15
Indonesia	1998	70	17	11
Korea	1998	35	16	20
Malaysia	1998	35	15	23
Thailand	1998	45	18	20

* Lower estimates include costs of funds, credit and bonds injected directly into the banking system; higher estimates include other fiscal costs, such as exchange rate subsidies.
Source: Reisen (1999)

Table 1.8 - Real GDP Growth Rates and Current Account Balance (as % of GDP) in Five Crisis Countries

	1996	1997	1998	1999	2000	2001	2002	2003
Indonesia								
GDP Growth Rates	7.8	4.7	-13.1	0.8	4.9	3.5	3.7	4.1
Current Account Balance	-3.4	-2.2	4.3	4.1	5.3	4.8	4.5	3.9
Korea								
GDP Growth Rates	6.8	5.0	-6.7	10.9	9.3	3.1	6.4	2.6[a]
Current Account Balance	-4.4	-1.7	12.6	6.0	2.7	1.9	1.3	n.a.
Malaysia								
GDP Growth Rates	10.0	7.3	-7.4	6.1	8.6	0.3	4.1	5.2
Current Account Balance	-4.8	-5.2	13.5	15.9	9.1	8.3	7.6	n.a.
Philippines								
GDP Growth Rates	5.9	5.2	-0.6	3.4	6.0	3.0	4.4	4.5
Current Account Balance	-4.8	-5.3	2.4	9.2	8.3	1.8	5.6	4.2
Thailand								
GDP Growth Rates	5.9	-1.4	-10.5	4.5	4.8	2.1	5.4	6.7
Current Account Balance	-7.9	-2.0	12.7	10.2	7.6	5.4	6.0	5.6

Sources: ADB (http://www.aric.adb.org), except for Korea in 2003 (a): official estimates.

IV. Development Lessons from East Asia and Policy Challenges for OECD Countries

In this final section, we recapture major development lessons from East Asia and discuss key policy challenges for OECD countries.

Recapturing Development Lessons from East Asia

As we discussed in Section II, several developing economies of East Asia simultaneously experienced major turnarounds in their catching-up growth process in the early 1970s and again in the mid-1980s (including China). It would be difficult to attribute such a coincidence either to some random factor or to a deliberate co-ordinated act on the part of their governments. We argue that behind the region's multi-layered catching-up process there were indeed significant changes in international economic environment. In terms of macroeconomic policy developments, easy monetary policy among OECD countries in the 1970s led to low real interest rates, and Asian NIEs found it easy to finance their strong investment demand by borrowing petrodollars recycled through banks in London and New York (Frankel and Roubini 2003). Relocation of labour-intensive manufacturing sectors among East Asian economies was also facilitated by a successive round of the yen's real effective appreciation and accelerated in the wake of the Plaza Accord of the dollar-yen currency realignment in September 1985. In the early 1990s, real interest rates in the United States and other OECD countries were once again low so that international capital went to East Asian (and other emerging) economies to earn higher returns. Thus, external macroeconomic factors, such as movements in interest rates and exchange rates among major OECD countries, have exerted an important impact on East Asian economies through trade and financial linkages (Chinn 2004).

The emergence of a trade-FDI nexus, namely, a positive relationship between unilateral liberalisation initiatives and strong trade and FDI performance, is another critical factor underlying East Asia's multi-layered catching-up process (Urata 2004,b). In this process, Japan and Asian NIEs have emerged as direct investors, as these economies are climbing up 'technological ladders' in industrial development and relocating labour-intensive activities to less advanced developing economies within the region. In other words, growth stimuli and incentives have been generated and transmitted from more advanced to less advanced economies in East Asia through continuous industrial restructuring and adjustment on the one hand and gradual reductions in trade and FDI barriers on the other. In particular, unilateral tariff reductions for parts and components in machinery industries, together with an extensive use of duty drawback system, have played a pivotal role in the formation of international production and distribution systems, thereby stimulating intra-regional trade and investment in manufactured goods, especially electronic products (Kimura 2004).

The economic ascendancy of China over the past 25 years should also be seen in this particular context. Lin (2004) evaluates the influence of major external factors on China's economic reform with reference to international aid and consultation, FDI and WTO accession. He argues that the impact of international aid on the country's reform process did not come from the volume of aid but from the exemplary effect of aid projects, so that aid played different roles in different stages of reform and development. International policy consultation also played an important role by enhancing the government's capability of designing and implementing economic policy. Lin also emphasises a critical role played by FDI in bringing advanced management and technology into China.

Soesastro (2004) presents an insightful account of the changing landscape of policy issues related to international aid from the perspective of ASEAN countries as recipients. In so doing, he takes up Japan as a case study, since the country has been the most important donors for East Asia. The paper highlights that there are diverging views among donors themselves on how aid *should* work. From the East Asian economies' point of view, aid has been seen as a useful vehicle to facilitate human resource development, improve both 'hard' and 'soft' infrastructure, promote SME development and create various institutions for industrialisation. But, emphasis among these priorities differs across recipients and over time. Soesastro thus emphasises the importance for the donor communities to come up with a viable 'menu' in terms of modalities and areas of development assistance, in which individual donors can specialise based on their comparative advantages. To make such a menu approach coherent, better and more effective co-ordination among donors become even more important.

Over the past few years East Asian economies have begun to embrace FTAs as a means to accelerate market opening and structural reform needed to sustain growth momentum within the region. They consider FTAs as an integral component of broader economic partnership agreements which include, among others, trade and FDI facilitation and development assistance. It is argued that the creation of an East Asian FTA covering the whole region would be economically desirable (see, for example, Cheong 2003 and Urata 2004a). The current initiatives to establish bilateral FTAs involving China and Japan on one hand and individual ASEAN 4 countries on the other might eventually end up with creating competing trading blocs within the region. So far there is no clear road map to establish a region-wide FTA in East Asia.

The lack of policy coherence is perhaps most prominent in the agricultural policy area. During and in the aftermath of the 1997-98 crisis, several ASEAN countries, most notably Thailand, were reminded that the agricultural sector played an important role in sustaining export earnings, supporting rural household income, and absorbing displaced workers, thereby contributing to economic recoveries and political stability. To be sure, the likely impact of the OECD-country agricultural policies on growth and poverty reduction in developing countries may differ significantly from one economy to another within the region (Barichello 2004). This critically depends, among others, on the extent to which the policies in question are affecting world agricultural commodity prices, the extent to which the domestic agricultural sector in East Asian economies is linked to those commodity markets and some other structural and institutional characteristics of their own economies. For example, Barichello argues that the effects of rice and sugar policies in OECD countries on poverty reduction efforts in East Asian economies are likely to be more substantial in Viet Nam than in Indonesia. In Indonesia, there is so much integration in the labour market that rural wage rates are largely exogenous to the rural and agricultural sector. This is less likely so in Viet Nam. Given that the rural labour market is less well integrated with the urban labour market, lower agricultural prices (caused by OECD-country agricultural policies) are likely to have a depressing effect on agricultural wage rates, hence having a more direct impact on rural poverty. This analysis highlights the importance (and added value) of comparative country case studies in policy coherence research.

Key Policy Challenges for OECD Countries

OECD countries play at least five essential roles in development. These roles are to:

- Help maintain peace and security, which is fundamental to the long-term growth and poverty reduction in developing economies;
- Get the macro agenda right, to avoid unintended policy shocks and create an enabling external environment conducive for private sector-led growth in developing economies;
- Promote an open and predictable international marketplace for goods and services on a multilateral and non-discriminatory basis;
- Strengthen governance structure on international investment and finance to facilitate the flow of capital and technology in developing economies and help maintain financial stability; and
- Provide official aid bilaterally or through international financial institutions.

As regards the last point, some further comments are in order. As reviewed in Section II, East Asia's development experience over the past 25 years highlights that it is critical for the economies of the region to strengthen productive and trade capacity so as to respond effectively to emerging market opportunities and challenges. The economic ascendancy of the world's two most populous countries, China and India, makes this task even more urgent. Donors have been called upon to help them in this regard. On the other hand, East Asian economies have also learned the hard lesson from the 1997-98 fallout that it is equally critical for the sake of social cohesion and political stability to manage financial risk and protect the poor and vulnerable more properly in the catching-up growth process. This requires their governments to strengthen the banking and corporate sectors, while at the same time improving social safety nets and establishing a good working partnership with civil society organisations. One again donors have been called upon to assist them. At the end of the day, donors will end up with a long list of priority sectors for development assistance; this is where the question of aid co-ordination comes into the picture (Soesastro 2004, p.24).

As noted earlier (see Box 1.1), the DAC/OECD regularly conducts a peer review of its member countries' aid policies, which now involves discussions on policy coherence. A key challenge for OECD countries is thus to improve this peer review function with a view to enhancing accountability in economic policy-making for development.

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Annex Table 1.1 –International Poverty Line and Poverty Incidence by Region

Panel A. International Poverty Line - $1.08 Per Day at 1993 PPP

Region	Headcount Index [a] (per cent)					Number of Poor (millions)				
	1987	1990	1993	1996	1998[b]	1987	1990	1993	1996	1998[b]
East Asia	26.6	27.5	25.2	14.9	15.3	417.5	452.4	431.9	265.1	278.3
(excluding China)	23.9	18.5	15.8	9.9	11.2	114.1	91.9	83.5	55.0	65.1
Eastern Europe & Central Asia	0.2	1.5	3.9	5.1	5.1	1.0	7.1	18.2	23.8	23.9
Latin America & Caribbean	15.3	16.8	15.3	15.6	15.5	63.6	73.7	70.7	75.9	78.1
Middle East & North Africa	4.3	2.3	1.9	1.8	1.9	9.3	5.6	4.9	5.0	5.5
South Asia	44.9	44.0	42.3	42.2	39.9	474.4	495.1	505.0	531.6	522.0
Sub-Saharan Africa	46.6	47.6	49.6	48.5	46.3	217.2	242.3	273.2	288.9	290.8
Total	28.3	28.9	28.1	24.5	23.9	1183.1	1276.4	1304.2	1190.5	1198.8
(excluding China)	28.5	28.0	27.7	27.0	26.1	879.8	915.9	955.8	980.5	985.7

Panel B. International Poverty Line - $2.15 Per Day at 1993 PPP

Region	Headcount Index [a] (per cent)					Number of Poor (millions)				
	1987	1990	1993	1996	1998b	1987	1990	1993	1996	1998b
East Asia	67.0	66.1	60.5	48.6	49.1	1052.3	1084.4	1035.8	863.8	892.2
(excluding China)	62.9	57.3	51.6	42.7	44.9	299.9	284.9	271.6	236.3	260.1
Eastern Europe & Central Asia	3.5	9.5	17.1	19.9	19.9	16.3	43.8	79.3	92.6	92.8
Latin America & Caribbean	35.5	38.0	35.0	37.0	36.4	147.5	167.2	162.2	179.8	182.8
Middle East & North Africa	30.0	24.7	24.1	22.1	21.8	65.0	58.7	61.7	60.5	62.3
South Asia	86.3	86.7	85.4	85.0	83.9	911.0	975.9	1017.8	1069.4	1095.8
Sub-Saharan Africa	76.5	76.3	77.7	76.8	75.5	356.6	388.2	427.7	457.6	474.8
Total	61.0	61.6	60.1	56.1	55.9	2549.0	2718.3	2784.7	2724.0	2801.0
(excluding China)	58.2	58.7	58.5	57.7	57.6	1796.6	1918.8	2020.5	2096.5	2168.9

Note:
a. Share of population Living in Households that Consume Less than the Poverty Line.
b. Preliminary
Source: Adopted from Chen and Ravallion (2000). Tables 2 and 3.

Annex Table 1.2 - Poverty Incidence in East Asia

(Headcount Index: percentages of the population living in households that consume less than respective international poverty lines)

	Cambodia		Indonesia		Lao PDR		Malaysia		Philippines		Thailand		Viet Nam	
	A	B	A	B	A	B	A	B	A	B	A	B	A	B
1990	48.3	83.7	20.6	71.1	53.0	89.6	0.5	22.7	19.1	53.5	12.5	47.0	50.8	87.0
1991	-		-	-	-		-	-	19.8	55.0	-	-	-	
1992	-		-	-	48.8	88.1	-	16.2	-	-	6.0	37.5	-	
1993	-		14.8	61.6	-		-	-	-	-	-	-	39.8	81.6
1994	-		-	-	-		-	-	18.4	53.1	-	-	-	
1995	-		-	-	-		-	13.3	-	-	-	-	-	
1996	36.7	76.9	7.8	50.5	41.3	83.1	-	11.5	14.8	46.5	2.2	28.2	25.4	70.8
1997	38.4	78.0	-	-	38.4	81.3	-	6.0	12.1	45.2	-	-	-	
1998	36.9	77.4	-	-	39.5	81.8	-	9.3	14.5	47.4	3.9	33.2	18.8	67.9
1999	39.6	78.2	12.0	65.1	36.7	80.5	-	8.1	13.0	46.1	4.3	32.2	18.0	67.3
2000	39.7	77.2	10.5	63.3	35.1	79.7	-	6.1	12.0	44.8	3.7	30.6	15.2	64.7
2001	38.1	76.1	8.9	60.5	32.6	78.3	-	5.2	11.3	43.9	3.2	28.5	12.6	61.3
2002^{p}	37.2	75.2	7.5	57.8	31.0	77.0	-	4.0	11.0	43.2	2.6	26.7	10.4	57.6

Notes:
A. $1.08 per day at $1993 PPP.
B. $2.15 per day at $1993 PPP.
p. World Bank Update November 2002.
- not available.
Source: Asia Recovery Information Centre (Poverty and Social Indicators available from: http://www.aric.adb.org/)

Annex Table 1.3 - Social Indicators by Major Region

	Life expectancy at birth (total, years)					Mortality rate, infant (per 1,000 live births)					Illiteracy rate, adult total (% of people ages 15 and above)				
	1960	1970	1980	1990	2001	1960	1970	1980	1990	2001	1960	1970	1980	1990	2001
East Asia & Pacific	39	59	64	67	69	129	78	53	43	34	..	44	30	20	13
Latin America & Caribbean	56	61	65	68	71	102	85	61	42	28	..	26	20	15	11
Middle East & North Africa	47	52	58	64	68	164	131	94	57	44	..	70	59	47	35
South Asia	44	49	54	58	63	147	129	115	86	71	..	68	61	53	45
Sub-Saharan Africa	40	44	48	50	46	151	134	118	110	105	..	72	62	50	38
Memo item:															
Least developed countries*	39	43	47	50	51	170	150	130	116	101	..	72	65	57	47

* Defined by UN.
Source: World Bank, WDI, 2003 (CD-ROM).

Annex Table 1.4 - East Asia: Social Indicators by Economy

	Life expectancy at birth (total, years)					Mortality rate, infant (per 1,000 live births)					Illiteracy rate, adult total (% of people ages 15 and above)				
	1960	1970	1980	1990	2001	1960	1970	1980	1990	2001	1960	1970	1980	1990	2001
Cambodia	43	42	39	50	54	147	128	110	80	97	..	51	45	38	31
China	36	62	67	69	70	132	69	42	38	31	..	47	33	22	14
Hong Kong, China	66	70	74	78	80	41	19	11	6	3	..	21	15	10	6
Indonesia	41	48	55	62	66	128	104	79	60	33	..	44	31	20	13
Japan	68	72	76	79	81	30	13	8	5	3	..	..	..	..	..
Korea, Dem. Rep.	54	60	67	66	61	85	52	32	26	42	..	..	..	..	..
Korea, Rep.	54	60	67	70	74	85	43	16	8	5	..	13	7	4	2
Lao PDR	40	40	45	50	54	155	145	135	120	87	..	61	52	43	34
Malaysia	54	62	67	71	73	73	46	31	16	8	..	42	29	19	12
Mongolia	47	53	58	63	65	126	102	97	77	61	..	5	3	2	2
Myanmar	44	48	51	55	57	169	122	94	91	77	..	30	24	19	15
Philippines	53	57	61	66	70	103	83	65	45	29	..	18	12	8	5
Singapore	64	68	71	74	78	35	20	12	7	3	..	27	17	11	7
Thailand	53	58	64	69	69	103	74	45	34	24	..	20	13	8	4
Vietnam	44	51	60	65	69	147	112	50	36	30	..	17	13	10	7

Source: World Bank, WDI, 2003 (CD-ROM).

Annex Table 1.5 – Net Capital Inflows in Five Crisis Countries ($ Billion)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Indonesia [a]									
Total capital flows, net	3.8	10.3	10.8	-0.6	-9.6	-5.9	-7.9	-7.6	-1.2
Direct investment, net	1.5	3.7	5.6	4.5	-0.4	-2.7	-4.6	-3.3	0.1
Portfolio investment, net	3.9	4.1	5.0	-2.6	-1.9	-1.8	-1.9	-0.2	1.2
Other capital flows, net	-1.5	2.4	0.2	-2.5	-7.4	-1.4	-1.4	-4.1	-2.5
Memorandum items									
ODA, net	1.6	1.4	1.1	0.8	1.3	2.2	1.7	1.5	
Changes in reserves	-0.8	-1.6	-4.5	5.1	-2.1	-3.3	-4.9	1.4	-4.0
Current account	-2.8	-6.4	-7.7	-4.9	4.1	5.8	8.0	6.9	7.8
Korea									
Total capital flows, net	10.8	17.4	23.8	-9.1	-7.7	13.2	12.9	3.3	2.3
Direct investment, net	-1.7	-1.8	-2.3	-1.6	0.7	5.1	4.3	1.1	-0.7
Portfolio investment, net	6.2	11.7	15.1	14.4	-1.2	9.2	12.2	6.7	-0.1
Other capital flows, net	6.3	7.5	11.1	-21.9	-7.2	-1.1	-3.6	-4.6	3.1
Memorandum items									
ODA, net	-0.1	0.1	-0.1	-0.2	-0.1	-0.1	0.0	0.0	
Changes in reserves	-4.6	-7.0	-1.4	11.9	-31.0	-23.0	-23.8	-7.6	-11.8
Current account	-3.9	-8.5	-23.0	-8.2	40.4	24.5	12.2	8.2	6.1
Malaysia [b]									
Total capital flows, net	1.3	7.6	9.5	2.2	-2.5	-6.5	-6.3	-3.7	-2.8
Direct investment, net	4.3	4.2	5.1	5.1	2.2	2.5	1.8	0.3	1.3
Portfolio investment, net	-1.6	-0.4	-0.3	-0.2	0.3	-1.0	-2.5	-0.4	-1.4
Other capital flows, net	-1.4	3.9	4.7	-2.7	-5.0	-7.9	-5.6	-3.5	-2.7
Memorandum items									
ODA, net	0.1	0.1	-0.5	-0.2	0.2	0.1	0.0	0.0	
Changes in reserves	3.2	1.8	-2.5	3.9	-10.0	-4.7	1.0	-1.0	-3.7
Current account	-4.5	-8.6	-4.5	-5.9	9.5	12.6	8.5	7.3	7.2
Philippines [c]									
Total capital flows, net	5.1	5.3	11.3	6.5	0.5	-2.3	-4.0	-0.4	-2.7
Direct investment, net	1.3	1.1	1.3	1.1	2.1	1.8	1.5	1.1	1.0
Portfolio investment, net	0.3	1.2	5.3	0.6	-0.9	6.9	0.2	1.1	1.9
Other capital flows, net	3.6	3.0	4.6	4.8	-0.7	-10.9	-5.7	-2.6	-5.7
Memorandum items									
ODA, net	1.1	0.9	0.9	0.7	0.6	0.7	0.6	0.6	
Changes in reserves	-2.1	-0.9	-4.0	2.6	-1.9	-3.9	0.1	-0.5	0.4
Current account	-3.0	-2.0	-4.0	-4.4	1.5	7.2	6.3	1.3	4.2
Thailand									
Total capital flows, net	12.2	21.9	19.5	-12.1	-14.1	-11.1	-10.4	-3.7	-2.7
Direct investment, net	0.9	1.2	1.4	3.3	7.2	5.8	3.4	3.5	0.8
Portfolio investment, net	2.5	4.1	3.5	4.5	0.4	-0.1	-0.7	-0.9	-1.6
Other capital flows, net	8.8	16.6	14.5	-19.9	-21.7	-16.7	-13.1	-6.3	-1.9
Memorandum items									
ODA, net	0.6	0.9	0.8	0.6	0.7	1.0	0.6	0.3	
Changes in reserves	-4.2	-7.2	-2.2	9.9	-1.4	-4.6	1.6	-1.3	-4.2
Current account	-8.1	-13.6	-14.7	-3.0	14.2	12.4	9.3	6.2	7.7

Note: a. No data are available for “outward FDI” and "portfolio investment assets" over 1994-2002 and for "other investment, assets” over 1994-1997; b. No data are available for ”outward FDI” and "portfolio investment, assets" over 1994-1998 and for "other investment, liabilities" over 1999-2000; c. No data are available for "other investment, assets" over 1994-1995.
Source: IMF, IFS Statistics and OECD/DAC, International Development Statistics (ODA).

Annex Table 1.6 - Major Areas and Programmes of Social Protection: Five East Asian Countries*

Areas	Indonesia	Korea	Malaysia	Philippines	Thailand
1. Social Assistance	Sale of subsidised rice	Social benefits under the 1999 GMI Act [b]	Social benefits provided by the Ministry of National Unity & Community Development [e]	Rice subsidy programme	Social services [j]
	Scholarships and block grants to school Subsidies for health care				Education subsidies and free lunch
2. Social Insurance	Limited social insurance schemes [a]	Social insurance system (under reform) [c]	Employees' provident fund (EPF) [f]	Social security system (SSS, GSIS, etc) [h]	Provident fund/ Employee Welfare fund
			SOCSO [g]		Social security fund Civil servants' pension scheme
3. Employment	Public work programmes	Vocational training	Micro-credit and other schemes for assisting the poor, small traders and agriculturers	Rural works programme managed by Department of Labour & Employment	Unemployment mitigation programme
		Temporary public work programmes Social integration through work (SIW) [d]			
4. Community-based Schemes	Community empowerment funds (e.g., public works)	SIW at the local level		ERAP *sari-sari* rolling stores [i]	Community-based development and welfare projects

1. Programmes to provide a minimum standard of living to the poor through subsidies for food, school and health care services.
2. Programmes to manage the risks associated with old age, unemployment, health, disability and work injury.
3. Programmes to create and facilitate employment.
4. Programmes to address the need for social protection at the community/local level.

* This table summarises information available on social protection programmes in five crisis countries and should be seen as illustrative rather than exhaustive.

a. Only available for employees in medium and large enterprises (Jamsostek), the public service (Taspen), and the military (Asabri).
b. The Guaranteed Minimum Income is an income supplement based on the difference between the poverty threshold and the total amount of resources.
c. Reform aimed at extending the coverage and lengthening the duration of benefits.
d. SIW programmes comprise vocational training schemes, jobs in work-experience enterprises and assistance for creating micro-enterprises.
e. A monthly allowance of RM 50 to homeless and destitute people over age 60 without families to support them.
f. A compulsory saving scheme whose aim is to provide uniform retirement and other benefits for its members. Similar schemes are available for government employees, the military and teachers.
g. Social insurance schemes relating to work injury, occupational diseases and invalidity.
h. GSIS - Government Service Insurance System
i. Enhanced retail access for the poor - a rolling store "sari-sari" is to provide low-cost rice and other basic commodities to remote areas.
j. Various social assistance projects run by Ministry of Labour and Social Welfare

Sources: Braga de Macedo et al. (2002).