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POLICY COHERENCE MATTERS

PROMOTING DEVELOPMENT IN A GLOBAL ECONOMY

This document contains the final version of the report, which will be published in the coming weeks.

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Preface

In 1996, OECD Ministers adopted a “development partnership strategy”, which envisages a reduction of one half, by the year 2015, in the proportion of people living in poverty in developing countries. This objective is based on UN conference outcomes and is widely shared, including by the World Bank. Reducing poverty is seen as vital for peace and stability and social and environmental well-being in developing countries themselves, but also as essential to the common well-being of the global community as a whole.

At their 1998 annual meeting, OECD Ministers welcomed the steady progress being made in implementing the OECD’s development partnership strategy. They noted however, that:

“The success of the partnership strategy will be based on increased policy coherence, especially to help developing countries secure sustainable development, assemble the necessary financial resources, and integrate successfully into the global economy”.

In that light they requested the OECD Secretariat to submit a report to their Meeting in 1999, on:

“the links between trade and investment and development, and the role that the OECD might play in promoting greater policy coherence”.

This report has been prepared in response to that mandate. It follows the 1996 DAC Report *Shaping the 21st Century: The Contribution of Development Co-operation*, which is the basis for the OECD’s partnership strategy for development. It also supplements the submission of a Secretariat report in 1998, *Open Markets Matter*, which assessed the benefits of open markets for the welfare of people in OECD countries and the world generally.

Drawing on the extensive literature on trade, investment and development, the report finds that by effectively engaging with the dynamic flows of trade, investment and knowledge in a global economy, developing countries can achieve high rates of growth, and that sustained high growth is effective in reducing poverty. However the report also finds, in line with the evidence, that while opening their economies to trade and investment is a necessary condition for developing countries to achieve sustained high growth through engagement in the global economy, it is by no means a sufficient condition.

The three basic foundations for sustained high growth in developing countries are:

- Sound, market-oriented economic policies.
- Appropriate social policy frameworks, including strong investment in human capital and adequate social safety-nets.
- Good governance.

Initiating a process of dynamic growth requires a minimum level of performance in each of these domains. Sustainable development over a period of decades requires continuous maintenance of coherent economic, social and environmental policies and fostering the political consensus needed to underpin them, implying a widening participation of the population in economic and political life. This implies, in turn, the development of private and public institutions that are transparent and accountable. As the Asian financial crisis helped to show, weaknesses in these domains make even successful developing economies vulnerable to crisis.

The key objective of this report is to identify how OECD countries can provide coherent support for the endeavours of developing countries to achieve sustainable development through effective participation in the global economy. Policy coherence requires the avoidance by OECD governments of policies that undermine other efforts they are making to help the development process (e.g. trade actions which reduce current income and potential growth run counter to aid policies that develop countries' export capacity). The notion of policy coherence also embraces the broader agenda of consciously taking account of the needs and interests of developing countries in the evolution of the global economy.

Part II of the report is devoted to these central issues of policy coherence. It looks at how OECD Members can design policy-making processes at home which systematically build "developmental coherence" into their decision-making across all relevant policy areas. It stresses the need to bring developing countries fully into the evolution and governance of the international trade, finance and investment regimes. These regimes provide the twin public goods of confidence and accountability needed by all actors in a dynamic and stable global economy. They also set international standards that work as a benchmark for the quality of policies and institutions, which can be particularly helpful for developing countries seeking to establish their reputation in terms of their economic and political environment. The report recognises the importance of helping to build the institutional capacity that developing countries need in order to be effective rather than vulnerable and marginal players in the global economy.

The outcome of the discussions at the 1999 OECD Ministerial Meeting was an agreement that policy coherence matters. Ministers agreed that policy coherence is an issue that must remain on the OECD agenda. They asked for further work, and for the Secretariat to report back on the results of such work.

Producing this report has involved an extensive process of discussion and feedback inside the OECD Secretariat, in a range of OECD Committees and within and among OECD Member governments. The preparation of the report was led by Kumiharu Shigehara, Deputy Secretary-General, with Richard Carey (Deputy Director of the Development Co-operation Directorate), Ulrich Hiemenz (Research Director of the OECD Development Centre) and John West (Secretary-General's Office) as the main authors. A companion report, *Reaping the Full Benefits of Open Markets*, which draws on some of the same material, but extends the analysis of the benefits of trade and investment liberalisation for developing countries, is being published simultaneously.

This report is published under the responsibility of the Secretary-General.

POLICY COHERENCE MATTERS
PROMOTING DEVELOPMENT IN A GLOBAL ECONOMY

Executive Summary

1. The linkages between trade, investment and development

Accelerating development progress through trade, investment and knowledge transfers in an open world economy

Trade, finance and investment, coupled with the new information and communications technologies, are the most powerful mechanisms for the transfer of human and organisational capacities, which are the foundations of development progress.

The new global economy is making available a vast and competitive range of goods, services, capital and knowledge at lower cost and with wider access than ever before. Potentially in this kind of world, the development process can advance more rapidly than ever before, with broader participation both across countries and within countries.

Developing countries are very much aware of this potential. Since most of the world's stock of knowledge is in the advanced countries, it is imperative that developing countries be open to trade and investment if they are to capture and internalise this knowledge. The thrust of development strategies of countries at all levels of development is now towards integrating with the world economy through policies which foster competitive national economies, including unilateral, regional and multilateral trade liberalisation.

Towards a "Millennium Round" of negotiations in the WTO

A new "Millennium Round" of negotiations in the WTO framework would allow developed and developing countries to bring together these converging interests and policies towards an open rules-based world economy. There is now a central common interest in carrying forward the process of liberalisation and in resolving the increasingly complex economic, environmental, social and political issues involved in the functioning of an open world economy, through the WTO and other relevant international fora.

It is vital that developing countries participate actively in the preparatory processes for a new Round. With a mutually-beneficial agenda addressing the interests and concerns of a wide range of developing countries, they have the prospect of considerable benefits from a new Round.

The linkages between openness and development

The evidence on the linkages between openness to trade and development progress shows that:

- Countries with open economic strategies grow faster and reduce poverty more than countries with closed economies. Economies that remain closed grow slowly if at all and poverty intensifies.

- Liberalisation of trade and investment is *a necessary but not a sufficient condition* for sustainable development progress and poverty reduction.
- Good governance, effective institutions, coherent economic policies and well-targeted social and infrastructure investments are essential.

Comprehensive development strategies are an essential complement

There are many challenges in initiating and implementing the comprehensive development strategies needed to reap the benefits of open trade and investment. But whatever the context, all countries face the challenge of implementing a minimum threshold of coherent and mutually-reinforcing policies and reforms:

- The quality of governance and institutions is fundamental.
- Political leadership is essential.
- The need for open trade and investment must be communicated.
- Coherent reform packages work better than piecemeal measures.
- Development strategies must be comprehensive and locally owned.

There are essential complementarities and synergies between the development of comprehensive domestic infrastructures of governance and institutional and human capacities on the one hand, and trade and investment liberalisation on the other. Both private and official actors seeking to advance trade and investment opportunities must give sufficient attention to these vital connections between trade and development liberalisation and domestic capacities. Failure to do so carries the prospect of poor development performance, serious economic and political dysfunction and financial crises.

Specific policy challenges

There are also a number of specific policy challenges:

- Structural adjustment and social policies - as the modern, formal sector expands, affordable and appropriate safety-net institutions are an essential part of a sustainable economic development strategy.
- Strengthening financial systems - sound financial systems are demanding in terms of legal frameworks, institution-building, human capital and corporate governance systems. OECD countries have a strong interest in ensuring that financial liberalisation is buttressed by capacity-building in the financial sectors of developing countries.
- Environmental sustainability - strong coherence between trade, investment and development and environment policies is needed to ensure their complementarity at the national, regional and international levels.

The role of development co-operation

- The transition from aid dependence to a market-based entrepreneurial economy must be underpinned by effective development co-operation to support social investments and the strengthening of governance and institutional frameworks and private sector development.

2. The “developmental coherence” of OECD policies

While the benefits of open trade and investment depend crucially on policy efforts undertaken by developing countries themselves, the capacity of developing countries to exploit these benefits also depends on the “developmental coherence” of the policies of OECD Member countries. Experience shows that a number of tools and mechanisms can be effective in taking into account the development dimension in overall policy making in OECD countries. These include:

- A common vision for articulating and evaluating policies.
- An effective framework of inter-ministerial co-ordination within capitals.
- Research and analytical capacities to support efforts to improve the developmental coherence of policies.
- Mechanisms for consultation with civil society to promote consensus-building in society on specific policy issues.

Areas in which the developmental coherence of OECD policies can be enhanced include:

- Strengthening the framework for international trade flows.
- Strengthening the framework for international investment and capital flows.
- Reconciling the environment with trade and investment and development.
- Enhancing access to the global information society.
- Improving the coherence of OECD Members’ development co-operation policies and practices.

3. The role of the OECD

As we look towards the twenty-first century, the weight of developing countries in the global economy is set to increase hugely. More than ever before, all countries have a significant stake in the global economy and the benefits that open trade and investment, and policy coherence can bring to economic development.

Developed and developing countries are working together through many channels to strengthen policies and institutions, and to address systemic issues, at both the national and the global levels, in order

to ensure that countries the world over can exploit fully the potentially great benefits of open trade and investment. A large number of international organisations are involved in this endeavour, including the IMF, World Bank, WTO, ILO and UNCTAD. The OECD is working with its Member countries to enhance the coherence of their policies for the sustainable development of non-OECD economies through its peer review processes and multidisciplinary analytical work. This involves helping to ensure greater developmental coherence across different policy areas in OECD Member countries, as well as greater coherence across OECD countries within each policy area.

In this context, at their meeting in May 1999, OECD Ministers agreed that:

- Greater coherence in OECD countries' policies is essential to the achievement of the international development targets emerging from UN conferences and monitored through the joint work of the OECD with the UN and the World Bank.
- They will continue to work together at the OECD to take greater account of the impact of their own policy frameworks in development countries.
- The OECD should undertake further analytical work on policy coherence, and report.

Introduction

1. Most developing countries are striving to accelerate their development by opening their trade and investment policies, and benefiting from the dynamism and the new opportunities in the global market place. Trade and investment are proving to be powerful vehicles for the transfer of knowledge, technology and organisational capacities, which are crucial to economic development.

2. Development, while closely linked to economic growth, is a much broader notion than growth. It involves a fundamental transformation of society, in which both governments and markets play important roles.¹

3. Thus, while openness² is essential for benefiting from the opportunities offered by the global market-place, alone it is not sufficient for achieving rapid and sustainable economic development. Openness involves more than the reduction of trade barriers and a welcoming environment for foreign investment. Political leadership is also critical to reform major areas of economic dysfunction, establish effective governance systems under the rule of law and manage the social transitions that accompany the liberalisation process. In other words, openness must be part of a coherent and mutually reinforcing set of policies and reforms in order to achieve rapid and sustainable economic development.

4. Recent financial crises have demonstrated some of the challenges involved in the rapid integration of developing countries into the global economy, including the need for appropriate macroeconomic and exchange-rate policies and strengthened institutions, and a healthy international monetary and financial environment. The scope and the costs of financial crises and their impacts on businesses, employment and social cohesion can be very high.

5. Developed and developing countries are working together through many channels to strengthen policies and institutions, and to address systemic issues, at both the national and the global levels, in order to ensure that countries the world over can exploit fully the potentially great benefits of open trade and investment. A large number of international organisations are involved in this endeavour, including the IMF, World Bank, WTO, ILO and UNCTAD.

6. The OECD is contributing in many areas, including through the OECD's development partnership strategy, of which the central focus is helping developing countries build their own capacities for development. More recently, the President of the World Bank made a proposal for a "Comprehensive Development Framework", which provides an implementing mechanism for this concept. The development partnership strategy includes developmental goals for economic well-being and reductions in poverty, social development, environmental sustainability and good governance. It also highlights the importance of the "developmental coherence" of the policies of OECD Member countries.

1. Stiglitz, Joseph E. (1998a), "Towards a New Paradigm for Development: Strategies, Policies and Processes".

2. There is of course no precise definition of "openness", and all countries retain at least some trade and investment barriers. A broad approach is to identify the point at which trade barriers, macroeconomic distortions and the role of the state are reduced sufficiently to create a market-oriented economy in which resources flow from inefficient uses into the competitive sectors (Sachs and Warner, 1995). Other approaches are more closely based on the level of trade barriers. One study has shown that a wide variety of measures of "openness" are positively linked to economic performance (Edwards, 1997a).

7. In the globalising world economy, OECD Member countries are increasingly taking into account the effect of their own policy frameworks on developing countries.

8. Against this background, this report:

- Examines the fundamental linkages and conditions which make openness to trade and investment in a global economy effective as part of a comprehensive development strategy.
- Underlines the importance of ensuring that OECD Members' policy-making processes take account of the need for "developmental coherence", setting out some of the main policy challenges of OECD Member countries' policies, and identifying roles the OECD can play in promoting developmental coherence.
- Presents in Annex 1 some trends and experiences which highlight the importance of implementing open trade and investment policies, in the context of a coherent and mutually reinforcing set of policies and reforms.

PART I: THE LINKAGES BETWEEN TRADE, INVESTMENT AND DEVELOPMENT

1. Accelerating development progress

a) *Capturing the dynamic potential of the new global economy through open development strategies*

9. Trade, finance and investment, coupled with the new information and communications technologies, are the most powerful mechanisms for the transfer of human and organisational capacities.³ The new global economy is making available a vast and competitive range of goods, services, capital and knowledge at lower cost and with wider access than ever before. Potentially in this kind of world, the development process can advance more rapidly than ever before, with broader participation both across countries and within countries.

10. Developing countries are very much aware of this potential and of the advances made by those who have been participating in the new patterns of trade, investment, technology and knowledge flows. The thrust of development strategies of countries at all levels of development is now towards integrating with the world economy through policies which foster competitive economies.

11. This thrust has not been altered by the experience of the financial crises in some dynamic developing countries. Indeed, policymakers in most of those countries are moving to correct underlying weaknesses in their own policies and institutions, and to increase their capacity to benefit from participation in the global economy.

12. The world's two most populous countries, first China and India more recently, have progressively (albeit in different degrees) embraced this strategy, bringing a further dimension to the dynamic prospects of the global economy. And with all of the world's labour force growth of nearly two billion people over the next 50 years forecast to be in developing countries (see Background Briefing Note 6), the patterns of the global economy will be increasingly shaped by their active participation and their contribution to its governance.

13. An overview of the linkages between openness and development and the benefits and the experience of developing countries in moving towards economic openness is set out in Annex 1 of this report. The key messages are that :

- Countries with open economic strategies grow faster and reduce poverty more than countries with closed economies, while economies that remain closed grow slowly if at all and poverty intensifies.
- Liberalisation of trade and investment is *a necessary but not a sufficient condition* for sustainable development progress and poverty reduction.
- Good governance, effective institutions, coherent economic policies and well-targeted social and infrastructure investments are essential.

3. In this paper, "investment" is defined essentially as foreign direct investment, while "finance" refers to all liquid financial assets, including portfolio investment through financial markets.

14. Economic openness has always been and remains a major domestic policy issue in both developed and developing countries, in terms of both its economic and social impacts. Most OECD countries continue to have restrictions and subsidies in certain areas of their economies where sectoral interests are strong or where public support is believed to be justified. And their liberalisation efforts have varied in major ways according to their national circumstances, often with long adjustment periods in difficult sectors. It is to be expected that the same conflicts between specific domestic concerns and overall economic growth will be reflected in the liberalisation process in developing countries. However, measures which sustain inefficient sectors have been shown to involve significant economic costs which developing countries can ill afford. Multilateral liberalisation agreements help both developed and developing countries to consolidate and enhance the process of domestic policy reform.

15. Most developing countries have been moving away from highly interventionist economic strategies which were based on the view that trade and investment instruments and other selective measures are necessary and effective instruments of development policy. Some of the dynamic Asian economies have made intensive use of such instruments within a market-based, outward-oriented development strategy. These instruments may have helped in some cases to create the confidence and the capacities of enterprises to compete in the world economy, although other dynamic countries have used such instruments much less. While at the level of principle, there is a case for selective interventions to support particular firms and industries where the potential exists for lowering costs over time through "learning by doing", the information base on future developments in individual product markets is intrinsically not available. And experience (including the financial crises in Asia) shows that selective interventions can create serious long-term distortions in financial institutions and structures, and industrial and regional patterns. For these reasons, both developed and developing countries are moving away from this kind of intervention.

16. Completion of the Uruguay Round of trade negotiations has resulted in broad-based tariff reductions and the easing of some of the important non-tariff barriers, strongly enhancing the prospects for reaping global welfare gains from further trade expansion. Efforts to calculate the benefits of the Uruguay Round suggest prospective gains of anywhere from one per cent up to about a five per cent increase in world GDP. Unsurprisingly, the countries with open domestic markets have been favoured, especially since their openness implies a relatively better capacity to adjust and adapt to new and emerging market opportunities.

17. While interventions to enhance economic growth will continue to have a role in developing countries in the future, these interventions will be more generally targeted to building the foundations of national competitiveness and will be compatible with WTO commitments. The fact that most of the world's stock of knowledge is in the industrial countries makes it imperative for developing countries to open to trade and investment as a means of capturing knowledge from abroad and internalising it.⁴

18. A new "Millennium Round" of negotiations in the WTO framework would allow developed and developing countries to bring together these converging interests and policies towards an open rules-based world economy. There is now a central common interest in carrying forward the process of liberalisation and in the resolution of the increasingly complex economic, environmental, social and political issues involved in the functioning of an open world economy, through the WTO and other relevant international fora. It is vital that developing countries participate actively in the preparatory processes for a new Round.

4. These are the conclusions reached in a recent review by ECLAC of trade and industrial policies in six Asian and Latin American countries (Argentina, Brazil, Chile, Indonesia, Malaysia and the Republic of Korea). See *Trade and Industrial Policies: Past Performance and Future Prospects*. Economic Commission for Latin America. October 1998. Available at www.eclac.cl. For analysis of the role of knowledge in development, see *1998 World Development Report*, World Bank.

With a mutually-beneficial agenda addressing the interests and concerns of a wide range of developing countries, they have the prospect of considerable benefits from a new Round.

b) *The domestic foundations: governance, policy coherence and comprehensive development strategies*

19. There are many challenges in initiating and implementing the coherent development strategies needed to reap the benefits of open trade and investment. Vested interests in public and private sectors, fears of the consequences of change, and the complexity and uncertainty of reform in specific economic, social and political contexts must be dealt with. Optimal approaches to structuring development strategies are highly variable according to context, such as the level of development and country-specific circumstances. But whatever the context, all countries face the challenge of implementing a minimum threshold of coherent and mutually-reinforcing policies and reforms.

The quality of governance and institutions is fundamental

20. How successfully and how generally the market economy is able to spread in a country depends on the degree of peace and security, the existence of predictable, clean and accountable government, and the rule of law backed up by an effective legal system. This requires significant investment in the creation of human and institutional capital.⁵

21. The domestic foundations of development lie in the evolution of an increasingly specialised division of labour. National networks of suppliers, distributors, wholesalers, retailers and service centres emerge, generating a continual process of social learning through the market economy. Interfacing with the world economy through trade and investment expands and intensifies the division of labour and social learning beyond what is possible on a purely national basis. The key to the emergence of a vibrant market economy in a developing country (and historically in OECD countries) is the creation of a favourable "transactions environment", which depends fundamentally on the quality of governance and the level of trust among networks of economic actors.⁶

22. In many of the developing countries at risk of being marginalised in the global economy, these requirements are seriously compromised or even effectively absent. A large number of poor countries are either in conflict or emerging from conflict, and suffer from pervasive predatory government characterised by the flight of human and financial capital and low investment in physical and human capital. The functioning of their economies thus falls well short of what is required for high and sustainable levels of growth, effective participation in the world economy, and the reduction of poverty.

23. The quality of governance and institutions is now being identified in empirical studies as a central determining variable in comparative development performance and in changes in performance over time. All countries, whether developed or developing, have an ongoing need to maintain and improve the institutional and policy environment which underpins economic performance and the emergence of a sustainable, competitive economy. Thus some of the most basic lessons to emerge from the recent financial crises centre around governance and institutional issues, particularly in the financial and corporate sectors but also in the area of legal systems and political accountability.

5. For an analysis of the role of institutions in development see *1999 World Development Report* on "Entering the 21st Century: Development Imperatives" (World Bank, forthcoming).

6. See Ben-Lon Chen, Chien-fu Jeff Lin, and Xiaokai Yang. "Empirical Evidence for the Endogenous Growth Generated by Evolution in the Division of Labour" (1999), Development Discussion Paper No. 671, Harvard Institute for International Development.

Political leadership is essential

24. Many problems, such as in the crisis-affected countries in East Asia, were not addressed adequately until they became acute, although they were foreseen years before. In all societies, opportunities for genuine reform of development strategies often come only after crises, when the hard lessons of inefficient policies have been learnt and external pressures are strong. There are, however, an increasing number of success stories. During the “lost decade” of the 1980s, Latin America changed in ways that were not thought possible. And just recently, Korea and Thailand, which have adjusted to crises in the past, notably in the early 1980s, are engaged in a range of policy reforms in response to the recent financial instability.

25. Skilful political leadership is needed to improve the capacity for change in the absence of crisis, and to design and implement strategies for liberalisation of trade and investment earlier to reduce the cost of lost opportunities and the pain of transition. Since the development process is highly contextual and country-specific, each country has to find its own way forward, and the effort to do so must be generated and sustained from the inside and on a broad basis. Liberalisation is not, therefore, a task only for governments; other stakeholders such as firms, workers and civil society more generally have roles in helping to build support for reform and in sharing information across borders. Multi-stakeholder approaches are also effective in promoting co-operative problem-solving in environmental management.

26. Active participation in international discussions, negotiations and agreements, with a view to enhancing domestic policy discipline and reaching international standards, can be an effective strategy for political leadership which is committed to improving economic performance.

Coherent reform packages work better than piecemeal measures

27. Open trade and investment need to be part of a coherent and transparent package of policies, for several reasons. When combined with macroeconomic stability and other structural reforms, as well as with appropriate social and environmental policies, the gains are greater, as resources can be more effectively re-deployed. The overall credibility of trade and investment liberalisation is enhanced. This is vital if the private sector is to respond with new investment patterns and workers are to accept that they will reap some of the benefits rather than simply bearing the risks. An integrated package of reforms facilitates balancing of multiple policy objectives and interests, including well-targeted policies to assist those whose livelihoods are undermined by change. In addition, affected parties have more warning of the need to adapt; vested interests have less opportunity to block change; and reform enjoys higher political profile and commitment.⁷

The need for open trade and investment must be communicated

28. The public needs to be informed as to why open trade and investment are considered so important to their future well-being. Open dialogue and communication, involving all major stakeholders on the benefits and costs of open trade and investment, can improve understanding on all sides of short- and long-term effects of action and non-action, and on the distribution of costs and benefits. In most developing countries, as in industrialised countries, open trade and investment would benefit from wider and more informed debates. Communication can strengthen the voices of those who support and benefit from open trade and investment. Important allies include: businesses which will gain from low cost, high-quality goods and services inputs; consumers; and employees in fields in which job creation and wage growth will benefit from open trade and investment.

7. Stiglitz, Joseph E. (1998a).

Main elements of a coherent development strategy

- A strengthening of governance systems, in particular:
 - An institutional and legal framework which supports the emergence of an enterprise-based economy and an efficient public sector.
 - Rising levels of participation in economic and political life as a basis for broadly-based growth, social cohesion and effective democratic institutions.
 - The development of a competitive environment which enhances the efficient functioning of markets.
 - Effective financial supervisory systems.
 - A good corporate governance framework providing for transparency of corporate structures and operations and the accountability of management.
 - And vigorous action to fight corruption and organised crime.
- Better co-ordination between different levels of government. Municipal administrations must manage rapid urban change, but in many cases lack the necessary funding and administrative capacities to do so.
- A consistent set of macroeconomic and structural policies conducive to higher domestic investment and the flow of economic and human resources into productive activities.
- Stable population growth, a growing human capital base through greater access to education and health services, and the development of science, technology and innovation policies.
- A strengthening of institutional and regulatory frameworks for identifying and managing environmental challenges and thus achieving sustainable development.

Development strategies must be comprehensive and locally-owned

29. The development objectives that have emerged from the series of major United Nations Conferences in the 1990s indicate a much wider consensus than existed in previous decades on the scope and the modalities of development efforts.

30. As captured in the 1996 DAC Report on *Shaping the 21st Century: The Contribution of Development Co-operation*, development goals encompass economic well-being, with major reductions in poverty; social development; environmental sustainability; and good governance. Moreover these objectives are interlinked. Generating dynamic economic growth, eradicating poverty, building up human and social capital, mastering environmental problems and establishing effective, democratic and accountable governance are seen as mutually-reinforcing agendas for sustainable development. The effective pursuit of these agendas depends primarily on the efforts of the developing countries themselves and in particular on committed leadership which generates wide national consensus and participation.

31. This is the basis of the development partnership strategy adopted by OECD Ministers in 1996.⁸ It is also the basis of the recent proposal by the President of the World Bank to co-ordinate development co-operation around a *Comprehensive Development Framework*, owned and managed by the developing country itself rather than by donors or international agencies, which integrates the economic and financial agendas with efforts to address fundamental long-term issues of the structure, scope and substance of human and societal development.⁹ This approach would provide a structured way in which policies to further open to trade and investment would be highly co-ordinated with efforts in the areas of physical infrastructure, social investment and the improvement of the quality of governance and institutions. The Comprehensive Development Framework is thus potentially a powerful tool for improving policy coherence in developing countries.

2. Managing the liberalisation process in developing economies: Some specific policy challenges

a) Structural adjustment and social policy in economic development

32. Successful economic development involves major structural adjustment, through a comprehensive process of societal change, with wide-ranging economic, social and political dimensions. In the early stages of economic development, the informal sector generates many jobs, and in some countries it can be very difficult to obtain the requisite permits to join the formal sector. As development gathers pace, the modern formal sector emerges as a dynamic force and the upgrading of the workforce and technology base becomes a more important factor. The development process also involves basic changes in the role of women in the economy, as is evidenced by the fact that the expansion of manufactured exports from the dynamic developing countries has been based on the emergence of a female labour

8. OECD (1996), *Shaping the 21st Century: The Contribution of Development Co-operation*.

9. See OECD Ministerial Communiqué, May 1996, and James D. Wolfensohn, "A Proposal for a Comprehensive Development Framework", Discussion Draft, February 1999. See also J.E. Stiglitz (1998b), "More Instruments and Broader Goals: Moving Towards the Post-Washington Consensus", in *Development Issues in the 21st Century*, German Foundation for International Development, Villa Borsig Workshop Series, 1998.

force.¹⁰ And the urbanisation process and the effective functioning of cities play a crucial role in the emergence of a competitive economy.

33. Government policies must stimulate these adjustment processes, when development is promoted through liberalisation of both trade and investment policies, and other reforms. In a rapidly growing economy, these policies can indeed facilitate the freeing of resources to other sectors and relieving resource bottlenecks. The experience of the emerging economies of East Asia shows that rapid development and structural change can take place, while maintaining very low rates of unemployment. And other empirical evidence suggests that adjustment costs in the form of workers being made redundant and firm closures have been rather modest in practice.¹¹

34. In neither developed nor developing countries has protection ever proven to be an efficient means of sustaining employment. Quite the contrary. Careful examination of the factors affecting employment shows that over time more jobs are created from a stronger export effort than are lost to imports; and jobs saved in protected industries are often offset by viable jobs forgone elsewhere in the economy. Furthermore, economies which have been characterised by pervasive protection and selective intervention very often exhibit high levels of sectoral and geographical concentration: there are definite losers, both region- and sector-wise, which can create social, economic and political backlashes, threatening the long-term sustainability of development.

35. Understandably, concerns are often expressed about the pace of liberalisation, as much as the direction of policy change, even though import liberalisation has generally been a medium- to long-term process. Firms, institutions and workers need to adjust in response to trade and investment policies. Workers and entrepreneurs engaged in these industries may face hardship as returns to their physical and human capital are altered. As people in developing countries adjust their lives to the growing formal sector, they necessarily loosen their relation with the informal and family networks on which communal life is based in a subsistence economy. This can make them vulnerable to social and thus economic deprivation, if they lose their job in the process of structural change, in an economic downturn or in the context of sudden economic shocks or crises. The overall process of structural change thus requires the development of new social frameworks and safety nets.

36. It is therefore important to build institutions, notably at the urban and regional level, which will cushion economic shocks, to supplement those appropriate to subsistence economies. Failure to provide structures which cater for the human casualties of adjustment can lead to social unrest which can severely retard economic reform. The development of affordable and appropriate social safety-net institutions can reassure populations that any negative consequences of openness and liberalisation will not fall disproportionately on them. Hence they have an essential role to play in the creation of a consensus in favour of such a development strategy. As in all economies, policymakers face the difficult challenge of trying to promote equity and efficiency gains by striving for social and labour market policies that provide transitional income security, while facilitating the redeployment of displaced workers into expanding firms and sectors.

37. There is no single model for social policy frameworks to deal with these problems and in developing countries this is a relatively new frontier. A number of international organisations are presently

10. OECD (1995e).

11. See Michaely, M., D. Papageorgiou and A. Choskie, "Liberalizing Foreign Trade: Lessons of Experience in the Developing World", International Monetary Fund; and Roenga, Anna, "The Effects of Trade Policy Reform. What do we really know?", NBER Working Paper No. 5225.

making major efforts to assess best practices and to assist developing countries in the design of appropriate social policies.¹²

b) *Strengthening financial systems*

38. Well-functioning financial systems are a crucial element in the process of development in a market-oriented economy and its interface with the global economy. As the recent financial crises in Asia demonstrate, sound financial systems are demanding in terms of legal frameworks, institution-building, human capital and corporate governance systems. OECD countries have a strong interest in ensuring that financial liberalisation is buttressed by capacity-building in the financial sectors of developing countries. Foreign direct investment in financial services is proving to be an effective way for developing countries to quickly develop professional human resources and financial standards and practices. As described in Part II, there is an important effort underway at the international level to strengthen prudential and supervisory systems, where weaknesses have contributed to the emergence of vulnerable financing patterns and practices in emerging markets.

c) *The challenge of environmental sustainability*

39. Open trade and investment policies can contribute to economic development by: improving the efficiency of environmental resource use; reducing existing distortions which may already be damaging the environment; and promoting the development, transfer, and adoption of more environmentally-friendly technologies. At the same time, existing social and environmental pressures can be amplified or redistributed by certain trade and investment patterns. However, the increasing weight of developing countries in the global economy is likely to shift the locus of pressures on the global and regional environments. The positive contribution of trade and investment to the overall efficiency of environmental resource use and to the diffusion of environmentally-friendly technologies and practices will be critical to global sustainable development.

40. The empirical evidence of the environmental effects of open trade and investment policies is mixed. On the one hand, there have been cases reported of environmental harm (most notably in natural resource extractive sectors) associated with foreign investments and/or increased international trade associated with the increased scale of economic activity that these policies promote. On the other hand, there is also evidence that foreign firms or products commonly embody better environmental practices and technologies. For example, foreign firms are often the first to respond to consumer pressures for “greener” products or production methods. On balance, available evidence¹³ suggests that the environmental effects of open trade and investment are positive in some sectors, countries, or circumstances, but can be negative in others.

41. The institutional and regulatory context in which the trade and investment takes place is therefore a critical determinant of the net environmental effects and thus for the sustainability of economic development. Establishing sound national policies and institutional frameworks for sustainable development in developing countries is therefore critical if the material gains from intensified trade and investment flows are fully harnessed to social and environmental progress. However, many developing countries, and particularly the least developed, still lack the basic capacity to establish and enforce

12. See World Bank (1999a), “Principles and Good Practice in Social Policy”, Note for Discussion by the Development Committee, April 1999. The OECD’s Department for Education, Employment, Labour and Social Affairs is currently co-organising studies of relevant social policy issues in four Asian countries.

13. Zarsky, Lyuba (forthcoming, 1999).

appropriate laws and regulations. Important weaknesses include a lack of regulatory stability and transparency, as well as a shortage of expertise in areas such as negotiating, contracting and competitive bidding. In some sectors, including mining, forestry or fisheries, this may make it more difficult to ensure the necessary balance of benefits between investors and host countries, and may also result in increased pollution and unsustainable production patterns. Unpredictable regulatory regimes encourage short-term rent-seeking behaviour and act as a deterrent to long-term investment.

42. In the wake of the Rio Conference in 1992, many developing countries have formulated national strategies for sustainable development. In this regard, development co-operation is increasingly helping developing countries to establish the economic, legal and regulatory frameworks necessary to provide a stable and attractive investment climate, while ensuring compliance with social and environmental rules and safeguards. Improving the coherence and complementarity of trade and investment and development and environmental policies at the national, regional and international levels is thus an important priority.

3. The role of development co-operation

43. There are strong synergies between development co-operation and the emergence of a trade and investment-led development process. While the emergence of a market-based entrepreneurial economy transforms financing patterns from aid dependence to reliance on growing domestic savings, supplemented by international financial markets and foreign direct investment, this takes time. During this transition period, which is likely to last some time for poorer countries, official development assistance and other official development financing can provide the key support for rising levels of social investment and the strengthening of participatory development and good governance. External assistance is also increasingly directed at supporting the emergence of a strong private sector, through capacity-building and the strengthening of legal and institutional frameworks, financial systems and trade facilitation.

44. Further, external assistance can play an important role in relieving the debt overhang of aid-dependent countries. The logic of current efforts to reduce both bilateral and multilateral debt stocks in poor countries is to tie the debt-reduction process to the shift to trade and investment-linked growth through policy reform, institutional change and social investment.

45. Development co-operation can also address poverty and social problems directly.¹⁴ The non-enforcement of some core labour standards, particularly the prohibition of child labour exploitation, is linked to issues of poverty and economic development. Development co-operation programmes can make a positive contribution by addressing the underlying causes. An important advantage of such positive mechanisms is that they produce concrete and practical results -- e.g., getting children into schools, helping strengthen labour codes or enforcement capabilities -- without generating major economic distortions or political frictions.

14. The OECD's Development Assistance Committee (DAC) is currently engaged in a two-year work programme to devise guidelines for the incorporation of poverty reduction in development co-operation policies, programmes and projects.

PART II: THE DEVELOPMENTAL COHERENCE OF OECD POLICIES

1. Promoting “developmental policy coherence” in OECD Member countries: Generic issues and approaches

46. While the benefits of open trade and investment depend crucially on policy efforts undertaken by developing countries themselves, the capacity of developing countries to exploit these benefits also depends on the “developmental coherence” of the policies of OECD Member countries.

47. In their own policy formulation, OECD governments usually have several, sometimes conflicting, objectives and have to take into account a wide range of domestic and international considerations, one of which is economic development. Their policies may not always be coherent with respect to the goal of economic development. Nevertheless, in the globalising world economy, OECD Member countries are increasingly taking into account the effects of their own policy frameworks on developing countries, and identifying needs and opportunities for strengthening their expertise on developing country issues.

48. Maintaining a development-friendly global economic environment is an important responsibility for OECD countries, which have a predominant share in world output, trade and capital flows. In the first place, by pursuing high sustainable growth paths, OECD countries can provide strong expanding markets for developing countries’ exports -- an engine of economic development. And by pursuing fiscal consolidation in a medium-term framework, OECD countries can reduce their dependence on international financial markets, thus facilitating access of developing countries to external savings at low and stable interest rates. By addressing macroeconomic imbalances within and between countries, OECD Members can work to avoid economic shocks which disrupt the international financial environment of OECD countries.

49. Building more coherence among policies of OECD countries is in the first place a question of commitment by the **political leadership**. In this regard, in 1996 OECD Ministers endorsed the development partnership strategy approved by the High Level Meeting of the OECD Development Assistance Committee (DAC) of that year. Policy coherence is central to this strategy, in which Ministers agreed to work to assure that development co-operation and other linkages between developed and developing countries are mutually reinforcing.

50. **Political co-ordination is also central to improving policy coherence.** This challenge involves government ministries and agencies, which are responsible for the whole range of public policy objectives, including sustainable economic development in developing countries. There is of course no single policy-making method or model for improving policy coherence. However, the experience of OECD countries shows that a number of tools and mechanisms can be effective in taking into account the development dimension in overall policy making. These include:

a) A common vision for formulating and evaluating policies

51. A major “vision” statement on policies towards development issued by the government in the form of a comprehensive announcement of principles and policies can provide a basic reference point for policy design and decision-making in all relevant parts of government, as well as a basis for presenting policy issues to the public. The absence of such a reference point can produce contestation among different parts of government and little systematic effort to evaluate policy impacts on developing countries.

Furthermore, there may be insufficient guidance for the growing range of policy makers who find themselves engaged with development issues in such fields as environment, trade, agriculture, investment, human rights, debt relief, financial stability, drugs, migration, governance, corporate ethics and culture.

b) An effective framework of inter-ministerial co-ordination in capitals

52. Policy coherence can only be achieved by systematic information-sharing and a permanent process of policy co-ordination within and among ministries. There needs to be an established framework for the smooth functioning of this process at both the formal and informal levels.

c) Research and analytical capacities in support of developmental policy coherence

53. Informed decision-making is a paramount tool of coherence: Key decisions must be taken on the basis of information and analysis that enable decision-takers to identify the costs of pursuing incoherent policies and to explain their choices. There are several bodies and institutions used in OECD countries for this purpose. Some countries have a public agency, undertaking research on future trends and working on particular topics at government request. Others have specialised research agencies operating in specific sectors. In addition, the private sector — businesses, independent research institutes, private universities or foundations — can provide valuable input. The OECD itself has a development research organ, the Development Centre, which contributes to the identification and understanding of coherence issues.

d) Mechanisms for consultation with civil society to promote broad consensus-building on specific issues

54. Balancing different interests in the process of policy formulation where development issues arise requires an early anticipation of possible conflicts by strengthening exchanges and communication with civil society, both nationally and internationally. Such efforts require organisational structures and resources.

2. Promoting developmental policy coherence: Some priority issues

55. OECD countries are supporting developing countries' efforts to exploit fully the benefits of open trade and investment by:

- Working to strengthen the framework for international flows of goods, services, capital and knowledge.
- Ensuring the full participation of developing countries in international rule-making.
- Helping developing countries to build the institutional, human and other capabilities needed to benefit from the global economy.

This section illustrates some of the priority areas and issues where the OECD contributes through its committee process and other activities to improving developmental policy coherence (see also Section 3 on the role of the OECD in promoting greater policy coherence).

a) *Strengthening the framework for international trade flows*

56. Open global markets for goods and services, based on multilaterally-agreed rules, are essential for exploiting the benefits of open trade and investment for development. In this context, OECD countries are endeavouring to lead by example in resisting protectionist pressures, maintaining open markets, and maintaining the momentum of liberalisation. Further multilateral trade liberalisation would be of benefit for both developed and developing countries. In this context, there is growing support for launching a new Millennium Round of multilateral trade negotiations, which would provide a framework for defining and meeting the needs and interests of both developed and developing countries into the next century. Some of the key trade policy issues of relevance to economic development are set out below.

- *Improving market access by lowering tariff barriers for manufactures*

57. The average developing country tariff applicable to other developing countries is 7.1 per cent (10.7 per cent applicable to OECD). The average (trade-weighted) OECD tariff applicable to developing countries is 4.5 per cent. There is significant scope for mutual reductions in sectors with high tariffs from which both developed and developing partners will benefit. Further reduction in tariff escalation — whereby tariffs increase progressively with the processed state of the product — can be particularly beneficial as it diminishes a bias against value being added in the exporting country.

- *Reducing other impediments to trade*

58. Progress in reducing a range of other impediments to trade would be of particular interest to developing countries, such as: promotion of transparency in government procurement, rules of origin, contingent protection, technical barriers to trade, sanitary and phyto-sanitary measures as well as remaining tariff quotas and quantitative restrictions. Certain “behind-the-border” regulations and practices greatly impede trade. Indeed, large benefits can be achieved by stimulating more competition in domestic and international markets through pro-competitive reform. A strong complementarity between competition policy and trade and investment policy has become increasingly recognised as a key element in the framework of global trade relations. This is an area where developing countries have scope to derive benefits.

- *OECD agriculture and fisheries policies*

59. Agriculture plays a pivotal role for the overall economic development of many developing countries, as do fisheries in some developing coastal areas. Growth in agriculture and the agro-food sector in developing countries stimulates development in non-agricultural sectors, which in turn results in increased employment and higher incomes. Farm policies of a number of OECD countries can disturb this process, in particular when price support and substantial border protection (including high tariffs and tariff quotas) predominate in the farm support system. The need to dispose of surpluses of OECD countries’ producers on international markets depresses revenues for developing countries and impairs the role of agriculture as an engine for their overall economic growth. Areas where action by OECD countries is important for developing country prospects include: improved market access; a progressive and effective reduction of price- and production-distorting policies; stricter disciplines on export restrictions; and a critical review of existing preference schemes.

60. In addition, the food-processing sector in developing countries can be encouraged by OECD countries opening their markets for processed products, as well as providing technical assistance to cope with stricter standards which can result in new technical trade barriers. Agricultural productivity in

developing countries would also benefit from support for agricultural research: investment in agricultural research has sharply declined during the past decade.

61. The fisheries management policies of OECD fishing nations can affect the exploitation of fisheries resources in developing countries. Some OECD countries have initiated access agreements with developing countries that have large fisheries resources. When they provide for equitable competition with developing countries' fleets, equitable trade treatment and capacity-building in developing countries, such agreements can contribute to developmental coherence.

b) *Strengthening the framework for international investment and capital flows*

62. The stable and effective functioning of international and domestic financial markets is of critical policy concern for the further development of emerging market economies and their integration into the world economy. The Asian and other recent financial crises have led to a shared recognition of the importance of strengthening financial systems, nationally and internationally, so as to enable countries to capture the full benefits of global markets and capital flows while minimising the risks of disruption. As OECD countries are the source of most international financial flows, they have a pivotal role to play.

- *Adjusting international principles and standards to the requirements of the global market*

63. There are a number of collaborative efforts underway for improving transparency and accountability through the implementation of common standards and sound practices on a world-wide scale. The OECD is participating in many of these efforts, such as the new Financial Stability Forum. It is also contributing through the OECD Corporate Governance Principles, which have been developed in consultation with other international organisations, including the World Bank, authorities of emerging market economies, the business sector, trade unions and other interested parties. The Principles are expected to serve as benchmarks for both Members and non-member economies in evaluating and improving the legal, institutional and regulatory framework for corporate governance.

- *Strengthening assistance to developing countries to reinforce their economic and financial infrastructures*

64. Through its co-operative activities with non-members, the OECD is supporting: the development of solid tax systems and tax administrations, thereby increasing national savings and avoiding over-reliance on international and national capital markets; the fight against corruption which strengthens confidence in the financial system of developing countries; reforms in state-owned enterprises, including their privatisation, which will further promote competition, productive and allocative efficiency in the economy and consumer welfare; and good social policy practices and social safety nets that help to protect people in these countries against boom-bust cycles in international capital flows.

- *Supporting the development of a multilateral framework for investment*

65. The value of foreign direct investment (FDI) to development is widely recognised, but developing countries often lack basic conditions to attract investment, including legal and regulatory infrastructure. Further, whereas the WTO provides a strong multilateral framework for trade flows, FDI flows are governed by close to 1 630 bilateral, regional, and plurilateral agreements of different scope and coverage, involving developing and developed countries. A multilateral framework for investment would advance policy coherence by improving the conditions for FDI. The commitment by host countries to

internationally-accepted standards would lower the risk threshold at which foreign firms are ready to invest in their economies.

c) *Reconciling the environment with trade and investment and development*

66. Countries increasingly recognise that the environment is a crucial economic resource and that its preservation is an integral part of open trade and investment policies. However, even where the political will and public support to address environmental issues are strong, developing countries often lack the resources, information, technology and capacity to ensure the environmental sustainability of their production and trade patterns, to meet the environmental demands of the global marketplace and to benefit from emerging opportunities of environmentally-friendly (“green”) trade.

67. The environmental performance of foreign-based investors can set an important example for domestic firms, and can act as a catalyst for the spread of environmentally-friendly technologies in host countries. The direct environmental benefits from these processes for developing countries can be significant, especially in terms of more efficient technologies and practices. The benefits for OECD countries can also be large, especially in terms of a more stable regulatory environment in which to do business (and a higher quality of the natural environment).

68. To address transboundary or global environmental problems (as well as the transboundary economic effects of domestic environmental problems), co-operative solutions based on international consensus, are both appropriate and possible, contributing to such results as improved institutional capacity in the developing country itself. They may also lead to environmentally-friendly financial and technology transfers, perhaps supported by development assistance or market access arrangements, or to international environmental agreements.

d) *Enhancing access to the global information society*

69. Information, and the knowledge and understanding of how to use it, are a key resource. The spread of information and communication technologies (ICTs) opens enormous opportunities for economic development. ICTs enhance the access developing countries have to information about technologies and markets, thus facilitating their participation in the global economy. If firms in developing countries absorb and exploit new ideas, methods and technologies, they can potentially leapfrog entire stages of industrialisation. ICTs also mitigate the disadvantages of geographic remoteness by permitting rapid communication with partners and customers. Some developing countries now competitively trade in information-intensive goods and services from routine functions such as data entry and airline booking, to more value-added processes such as software production or the provision of professional services. Furthermore, the spread of ICTs can help enhance the transparency of transactions — with the public sector and among private actors — thus diminishing the uncertainties of commerce in developing countries. But ICTs also present a formidable challenge for developing countries. Failure to tap into these new technologies could widen the gap which separates developing from developed countries.

70. Facilitating the access of developing countries to ICTs requires narrowing the technology and information gap with developed countries in order to (i) tap into the global knowledge base, (ii) conduct R&D to address domestic needs; and (iii) both diffuse information broadly and absorb it rapidly. One crucial issue is achieving balance between incentives that generate new knowledge and incentives which help diffuse knowledge broadly in intellectual property regimes. It is also necessary to develop an efficient information infrastructure in developing countries, build ICT skills, facilitate Internet access and include developing countries in rule-making in the area of electronic commerce.

71. Removing the impediments to participating in the global information society is also important. For this, developing countries need to set up relevant legal frameworks and technical standards, and establish the institutional structures necessary for a modern system of intellectual property protection. This would be facilitated by further removal of trade barriers by all countries, building on the Information Technology Agreement which was concluded in 1997. To enhance developing countries' participation in and their ability to benefit from scientific research, they need to be more actively included in international scientific networks.

e) *Improving the coherence of OECD Members' development co-operation policies and practices*

72. Coherent development co-operation policies are a prerequisite for their effectiveness in reducing poverty and promoting development. However, to establish coherence in practice is far from easy. Donors may want to use their development co-operation projects and programmes to pursue at the same time a number of different and sometimes incompatible goals:

- They have to balance a multitude of diverging domestic and foreign policy interests with due regard to fiscal prudence.
- They are under pressure to quickly disburse available aid funds and to show results, while knowing that development needs a long-term approach where quick results are the exception rather than the rule.
- Their programmes commonly consist of a multitude of instruments ruled by different regulations and procedures, with implementation scattered over various organisations, making internal co-ordination and coherence difficult.

- *Untying aid*

73. It is necessary to confront the issue of tied aid, which raises costs, reduces the role of competition and restricts the development of the local private sector in developing countries. It is contrary to the market-based principles of the development partnership strategy. It is often supply-driven by the governments of OECD Member countries and firms when it should be demand-led, meeting developing country priorities and capacities. The action agenda for OECD Members consists of: working in the OECD Development Assistance Committee (DAC) towards the untying of aid to the least developed countries; assisting developing countries to strengthen the capacities needed to realise the benefits of untying; and strengthening co-ordination in capitals between aid and, where relevant, export credit agencies, to ensure that tied aid is used only to support developmentally and environmentally sound projects and does not displace financing that should be available on market terms, in accordance with the Arrangement on Guidelines for Officially Supported Export Credits.

- *Operationalising the development partnership strategy*

74. It is necessary to align aid practices and procedures with the OECD partnership principles -- the multiplicity of donors and their different aid procedures are a burden on developing country efficiency and ownership. The developing countries' institutional capacity is further weakened when donors absorb effective local professionals in the administration of their aid programmes in the field. Donors should co-operate among themselves and with recipient governments to create development partnerships in the field, encourage national leadership, assist institutional capacity development and end the proliferation of projects. The volume of aid needs to be appropriate to the implementation of country-specific partnerships and the achievement of the internationally-agreed development goals.

- *Private sector development and capacity-building*

75. Developing countries need a flourishing private sector if they are to participate in the global economy. Building and strengthening the policy frameworks and institutional infrastructure essential to private sector development has thus become a central priority. OECD Members are extensively involved in assisting these efforts in both developing and transition countries. In the DAC framework, broad orientations and practical strategies have been set out in the 1995 Guidelines for Support of Private Sector Development. In the light of current challenges, areas receiving special attention are: trade capacity; financial systems; and infrastructure.

- *Carrying forward the debt strategy*

76. Underpinning private sector-led development and creating the fiscal space for higher social investment requires an effective strategy towards debt reduction in highly-indebted poor countries. The Cologne Summit has generated an agreement among the G8 countries to improve significantly the HIPC initiative, in terms of broadening, deepening and speeding-up the impact of the scheme. A key issue of policy coherence now is to ensure that the increased cost of the scheme is fully met by additional finance, without the direct or indirect diversion of funds from aid budgets and facilities. A further coherence issue is to merge the debt-reduction schemes for individual countries into the development strategy of that country and its development partnership framework (e.g. its Comprehensive Development Framework) so that debt reduction is managed in an overall financial and policy context. This is the only way in which the link between debt reduction and the achievement of basic development goals, such as poverty reduction, can be assured.

- *Good governance*

77. For any developing society, building the institutions and practices of good governance is fundamental to the functioning of the private sector, to the sustainability of development and to the prevention and management of conflict. The issues involved are complex and sensitive, but better governance is now a recognised high-priority agenda item in most developing countries and has become accepted as a central and legitimate area for international co-operation. OECD Member countries are engaged in this effort in many ways and at many levels. They can draw on substantive results achieved in a number of key areas, through co-operation in the OECD framework, including established OECD agreements, guidelines and principles:

- Public management and corporate governance.
- Corruption and money-laundering disciplines.
- The good governance agenda in development partnerships based on local ownership.
- Coherent approaches towards conflict prevention and peace-building.

3. Promoting developmental policy coherence: The role of the OECD

78. Both developed and developing countries are working together through the whole range of international institutions to help developing countries secure sustainable development and integrate successfully into the global economy through greater policy coherence. In particular, they are seeking to strengthen policies and institutions, and to address systemic issues at both the national and global levels in order to build a robust global economy which delivers mutual benefits.

79. The OECD is working with its Member countries to enhance the coherence of their policies for the sustainable development of non-OECD economies through its peer review processes and multidisciplinary analytical work. This involves helping ensure both greater policy coherence *across different policy areas* in OECD Member countries, and greater coherence *across OECD countries* in each policy area.

80. In particular:

- Policy coherence issues are addressed by the OECD Development Assistance Committee (DAC) in its peer reviews of OECD Member countries' aid policies. More generally, the DAC serves as an overall liaison point for coherence in the aid system, by identifying and disseminating best practices, and by providing a platform for surveying and monitoring the progress made in implementing the OECD's development partnership strategy.
- Strengthening the framework for international trade flows by resisting protectionist pressures, maintaining open markets and sustaining the momentum of liberalisation goes to the heart of the OECD's Trade Committee — particularly in support of preparations in relation to market access for goods and services for a Millennium Round of multilateral trade negotiations. The OECD also monitors agricultural policies through calculation of producer support estimates and evaluation of alternative policy options, and is now assessing the impact of OECD Members' subsidies on fisheries' resource use and sustainability.
- The OECD also undertakes some activities, in co-ordination with the activities of other international organisations, for strengthening the framework for international investment and capital flows. It has done extensive work on investment policy matters, and can serve as a forum for a broad-based confidence-building policy dialogue on all aspects of a multilateral framework for investment. The current review of the OECD Guidelines for Multinational Enterprises offers an additional dimension to this dialogue. Other issues in support of international investment and capital flows are the OECD's Tax Codes and Anti-Bribery Convention, and the Corporate Governance Principles.
- The OECD's comparative advantage in multidisciplinary work enables it to work for greater coherence across OECD countries in major policy areas. For example, the OECD has a three-year strategy for work on sustainable development in the areas of climate change, technological development, sustainability indicators, and the environmental impact of subsidies. An issue of particular importance for this report is reconciling international trade and investment with environmental sustainability. The OECD monitors relevant policies and agreements, and establishes agreed methodologies and best practices to ensure that trade and investment policies on the one hand, and environmental policies on the other, are mutually supportive.

81. The OECD also has an important programme of activities which enable non-members to participate in and contribute to the Organisation's work.

- This includes a wide range of policy dialogue between Members and non-members. At their meeting in April 1998, OECD Ministers indicated that this ongoing mutually-beneficial dialogue should focus increasingly on issues of importance for the successful integration of non-member economies into the international economic system.
- In this context, high priority is being given to policy dialogue in the areas of: integrating non-member economies into the multilateral trading system and global capital markets; strengthening human resource development and the public sector's capacities for economic management; promoting social stability and equity; supporting structural adjustment; and

helping developing countries reap the benefits of the global information society, in light of the critical importance of information access to development; and the emergence of electronic commerce as a new opportunity and challenge.

82. As we look toward the twenty-first century, the weight of developing countries in the global economy is set to increase hugely. More than ever before, all countries have a significant stake in the global economy, and the benefits that open trade and investment, and policy coherence can bring to economic development.

83. In this context, at their meeting in May 1999, OECD Ministers agreed that:

- Greater coherence in OECD countries' policies is essential to the achievement of the international development targets emerging from UN conferences and monitored through the joint work of the OECD with the UN and the World Bank.
- They will continue to work together at the OECD to take greater account of the impact of their own policy frameworks on development countries.
- The OECD should undertake further analytical work on policy coherence, and report.

ANNEX 1: TRADE AND INVESTMENT AND DEVELOPMENT LINKAGES: TRENDS AND EXPERIENCES

1. Trade and investment – some trends

1. Trade between developing and developed countries during the 1950s and 1960s involved mainly the exchange of commodities for manufactures. But led initially by the four dynamic Asian economies (Hong Kong, Korea, Singapore and Chinese Taipei), the world trade and investment scene began changing markedly.

2. Following in their footsteps, other developing and then transition economies started abandoning state-led, inward-oriented strategies adopted in the post-War period¹⁵. Since the mid-1980s, over 60 developing countries have unilaterally lowered their trade barriers, 26 have joined the WTO and over 20 are in the process of joining. Similarly, many developing countries are now liberalising previously restrictive policies towards foreign direct investment¹⁶. A number of emerging economies in Asia and Latin America and transition economies in central and eastern Europe are now active participants in world trade and investment.

3. Developing countries' share of world trade has now risen to 30 per cent, compared with less than 20 per cent fifteen years ago, and their exports of manufactures more than doubled between 1980 and 1996 to reach 84 per cent of their total exports. There has also been a significant increase in trade among developing countries which rose from 31 per cent to 37 per cent of total developing country trade over the last decade.

4. While domestic savings are by far the major source of finance for investment in developing countries, foreign capital is also an important source of development finance. Thus, the 1990s have seen: a steady increase in net direct investment inflows; large amounts of other types of more liquid private capital flows (portfolio investment, bank credit and bonds); and a decline in official development assistance.

5. The pace of integration of developing economies into the global economy has been very uneven. Africa's share of world trade has continuously declined since the late 1960s, and the continent has been largely bypassed by the surge in private capital flows and is still overwhelmingly dependent on ODA¹⁷.

6. It goes without saying that developing countries are at various stages of development. And the domestic policy requirements and challenges for realising the benefits of open trade and investment can differ greatly between developing countries. Nevertheless, there is mounting evidence that developing economies, at all levels of development, have benefited from open trade and investment policies. Some evidence of these benefits is reviewed in the accompanying box.

15. World Trade Organisation (1998a).

16. OECD (1998g).

17. OECD (1997d).

Benefits of open trade and investment for development

- Open economies have grown significantly faster than closed economies over sustained periods of time. Income levels of “open” developing economies have been converging towards developed countries, as they have achieved substantially higher per capita income growth than the OECD average (2.3 per cent from 1970-89). On the other hand, income levels of closed economies have fallen even further behind and income gaps have widened not just vis-à-vis “open” developing countries, but also the OECD average (Background Briefing Note 1).
- Among open economies at all levels of development, participation in world trade and investment has spread (Background Briefing Note 2).
- With open trade and investment generating higher growth, the evidence is that this growth has also been associated with reductions in poverty. A recent study found that 77 out of 88 decade-long periods of growth were accompanied by reductions in poverty. Indeed, on average the income of the poor tends to grow proportionately to the average income of the entire population, although there are cases where the income of the poor grows more slowly and more quickly than the average. In countries where incomes are initially fairly unequal, higher openness and growth work to reduce these inequalities, whereas in countries where incomes are initially fairly equal, higher openness and growth tend to make income shares less equal (Background Briefing Note 3).
- The benefits of open trade and investment for economic development do not depend on initial income levels (Background Briefing Notes 4 and 5).
- There has also been a positive association between successfully sustained trade and investment liberalisation and improvements in core labour standards. An OECD study¹⁸ found that, as open trade and investment has contributed to economic development, there has also been a positive association of these policies with improvements in core labour standards, namely, elimination of child labour, the prohibition of forced labour, freedom of association, the right to organise and bargain collectively, and non-discrimination in employment. At the same time, there is no evidence that countries with low core labour standards enjoy a better global export performance (or attract more FDI) than high-standards countries.
- There is also some empirical evidence that human capital investment has a significant positive impact on economic growth in open economies, but far less in closed economies which tend strongly to misallocate and under-utilise human capital. One study found that high school enrolment rates in East Asia accounted for 38 per cent of the predicted difference in economic growth between East Asia and Latin America in 1960-90¹⁹. Indeed, data indicate that many of the high growth economies in East Asia have had the combination of outward-oriented policies and high literacy rates. This was notably the case in Korea, whose literacy rate was already 71 per cent in 1960 compared with an average of 29 per cent in other low-income countries²⁰. By contrast, Argentina, which pursued inward-looking policies, was unable to achieve sustained economic growth until the last decade, despite its well-educated population.

18. OECD (1996c).

19. World Bank (1993).

20. OECD (1996), Economic Survey, Korea

2. External opening policies for economic development: implementation and adjustment

- *Role of trade in development*

7. *Access to global markets* has allowed many developing countries to achieve economies of scale through new market opportunities, and upgrade their production and exports to higher technology and higher value-added products. In the post-war era both Hong Kong, China and Singapore developed large export-oriented domestic manufacturing sectors and passed through a similar set of industries, moving from textiles to clothing to plastics to electronics and, most recently, from manufacturing to banking and financial services.

8. The Malaysian economy has been transformed in only one generation from primarily a commodity exporter to one in which manufactured goods — mainly electronics — represent almost three-quarters of total exports.²¹ Korea established new industries and acquired new technology, with exporters often drawing on foreign buyers for product-design technology and for product improvement. Thus, the share of labour-intensive exports (notably textiles, apparel and footwear) declined while the share of more technologically advanced products, such as electronic goods and cars has risen.²²

9. Countries as diverse as Mauritius, Burkina Faso and Chile (see further below) have been able to diversify their export base by taking advantage of the scope for trade based on product differentiation and niche markets in both manufacturing and agriculture.

10. The lowering of trade barriers in successive multilateral trade rounds has contributed to the success of development strategies geared at participation in global markets. However, benefits from free access to foreign markets do not come automatically. Trade barriers against countries in Sub-Saharan Africa have been significantly lower than those applied to more successful developing countries in Asia, but domestic policies, including high levels of protection, have blocked the growth of their exports.²³

11. An instructive case is the economic development in the South East Asian countries of Malaysia, Thailand and Indonesia, which has outstripped that of African countries like Côte d'Ivoire, Ghana, and Nigeria (Background Briefing Note 4). Even after the financial crises their current income levels are a multiple of incomes in the three African countries. Three decades ago these economies were in the same income range and had similar resource endowments. The evidence is that a favourable attitude to the private sector and placing the development of exports at the centre of the development strategy were crucial factors in the superior development performance of the South-East Asian countries.

12. *Import liberalisation* has proved to be a powerful catalyst for development. It frees resources to be employed in activities where developing countries can become internationally competitive, lowering costs of production and laying the basis for dynamic export growth. It facilitates technology transfer, and provides firms with access to a richer array of capital goods and intermediate inputs as well as contacts with suppliers. It creates a competitive environment for domestic firms, thereby encouraging innovation, reducing costs and increasing price competition to the benefit of consumers, particularly where previously there was monopoly power.

21. OECD (1998b).

22. OECD (1996), Economic Survey, Korea.

23. See Yeats, Alexander J., Azita Amjadi, Ulrich Reincke and Francis Ng, IMF (1996), "What Caused Sub-Saharan Africa's Marginalisation in World Trade?", *Finance and Development*, International Monetary Fund.

13. Because of the strong links to the creation of internationally-competitive economies, import liberalisation is increasingly implemented by developing countries as an important element in their overall reform programmes. In some East Asian economies, governments played a strong hand in economic development by directing industrialisation, through selective interventions and selective openness to imports. However, when world-wide recession and inflation struck in the early 1980s, some of these East Asian economies (notably Korea and Chinese Taipei) launched import liberalisation programmes as part of a strategy to boost export earnings, while most other developing countries lifted import barriers. This import liberalisation is continuing to this day²⁴. Some of the economic distortions caused by these selective interventions created vulnerabilities that led to the recent financial instability.

14. In 1974/75, Chile launched an impressive programme of import liberalisation, reducing very high levels of protection to make Chile's trade regime the most transparent and open of all South American countries. In 1979, the government began pegging the nominal exchange rate to the US dollar as an anchor against inflation. But without macroeconomic and structural policies to keep inflation under control, a much over-valued exchange rate adversely affected exporters and adjustment in the import-competing sector. Following the debt crisis in 1982, the government continued trade liberalisation, but in conjunction with a competitive exchange rate, more stable macroeconomic policies and other structural reforms. Improved coherence between trade and other policies has helped exports to become an important engine of growth.

15. Import liberalisation has also been an integral part of the general reform strategy of most transition economies in their transition to market economies. Its role in price liberalisation and its contribution to competition policies has been considered essential to initiate necessary restructuring and modernising of production structures, as well as to foster integration of these economies in the world economy. Most transition economies quickly re-oriented their trade away from the planned CMEA system to market-oriented trade with OECD Member countries.

16. The appropriate pace and sequencing of import liberalisation depends on country-specific circumstances such as the initial degree of restrictiveness of the trade system and short-term adjustment costs. Where countries rely excessively on tariff revenues for financing public expenditure, import liberalisation should first begin by converting non-tariff barriers into tariffs and reducing peak tariff rates. These efforts should be accompanied by reforms of the tax system to broaden the tax base and ultimately to replace tariff revenues by tax revenues. Another critical element is the credibility of import liberalisation. Policymakers have a strong interest in ensuring that liberalisation is viewed as sustainable, rather than a zig-zag process, as observed in many African countries. Enterprises will make appropriate adjustments and investments if they are given clear and convincing signals.

- *Role of capital flows in development*

17. The liberalisation of international capital movements can bring about significant benefits. It provides economic agents with a greater choice, financial assets and liabilities, thereby facilitating portfolio diversification. For an open economy exposed to both domestic and foreign shocks, the freedom of capital movements may provide scope for a smoother absorption of these shocks. At the global level, international capital movements can reinforce the effects of trade in realising an efficient allocation of resources, with enhanced economic welfare worldwide.

18. The development contribution of *foreign direct investment* (FDI) flows is now widely recognised.²⁵ Over the last decade, it has outpaced trade flows and brought benefits to consumers in the

24. OECD (1994a).

25. UNCTAD (1999).

form of lower prices, greater selection and improved services (such as for telecommunications). And in the context of turmoil in financial markets, the relative stability of FDI is more evident than ever before. Studies have found that higher FDI flows (relative to debt) are associated with a lower probability of international financial crises.²⁶ While Korea achieved high economic growth with limited FDI inflows, there was a growing recognition, from the early 1980s, that restrictions on FDI were hampering transfers of technology into Korea. Efforts to encourage FDI were not very successful until the early 1990s. Following the recent financial crisis, Korea has moved drastically and fundamentally to improve the environment for FDI.²⁷

19. The links between open trade and investment and development are clearly demonstrated by a recent study on 34 developing countries.²⁸ It showed that FDI inflows into countries with open trade policies had a positive impact on economic growth, while it had no significant impact on countries with inward-oriented policies. Foreign investors can contribute to economic growth because they tend to be more productive than local firms. An analysis of 282 pairs of foreign and domestic firms of similar size drawn from 80 manufacturing industries in Brazil concluded that foreign firms have a significantly higher ratio of value-added to output than domestic firms. Through direct competition in the local market and through the demonstration effect of foreign producers on local firms, foreign MNEs can raise productivity levels in the sectors in which they are present. Blommstrom and Wolff (1989) estimate that the rate of productivity growth of local firms in Mexico is greater in those sectors in which foreign investors are more active.²⁹

20. Clearly there are powerful direct and indirect mechanisms through which foreign direct investment, in a favourable policy environment, works to create technical and managerial know-how, jobs and work skills and to improve the application of industrial law and good environmental practices. The links between FDI and trade have become key pathways forward in the development process and a vehicle for integration into an increasingly competitive global economy. This is very different from the role that foreign investment played under inward-oriented development. Under inward-looking development strategies in the post-war period, many Latin American countries redirected resources away from agricultural and primary products and towards industry, and attracted large amounts of foreign investment. Growth and investment averaged 6 and 8 per cent per annum respectively between 1965 and 1981. However, the “infant” manufacturing industries continued to rely heavily on protection through the 1980s, without the benefit of competitive pressures and technological progress to improve efficiency. When the late 1970s and 1980s brought a series of external shocks through oil and commodity prices, Latin American governments were ill-equipped to adjust.³⁰

21. Although sensitivity about foreign penetration in certain economic sectors (“strategic industries” in particular) continues to persist in a number of developing economies, many of them have been shifting from a cautious to a welcoming stance in their foreign investment policies. In particular, allowing the establishment of foreign companies and their participation in local firms enhances competition in general, as well as increasing the know-how and efficiency of domestic enterprises.³¹

26. Frankel, Jeffrey and Andrew K. Rose (1996); Graciela L. Kaminsky and Carmen Reinhart (1997).

27. OECD (1998), *Economic Survey, Korea*.

28. Balasubramanyam, V.N., M. Salisu and D. Sapsford (1996).

29. Cited in OECD (1998b).

30. OECD (1994a).

31. See OECD (1998b), *Foreign Direct Investment and Economic Development: Lessons from Six Emerging Economies*.

22. Countries like India, which had a very restrictive and highly selective policy towards foreign investment, have undertaken significant reforms. In the past, important areas of the Indian economy remained closed to private investment, and therefore to foreign investment. Even in areas open to private investment, foreign direct investment was allowed only selectively, with a preference for cases involving technology transfer, while foreign investment in the secondary capital was not allowed at all. In 1991, the very first year of Indian reforms, a radically new approach to foreign direct investment was implemented, and FDI is now permitted in virtually every sector of the economy. Although many restrictions still remain, FDI liberalisation is continuing.³² Recent decisions include further liberalisation of the power and telecommunications sectors. Faster liberalisation of both trade and investment, in combination with sound macroeconomic policies and social and infrastructure investment in poor rural areas, would enable India to achieve sustained high rates of per capita income growth.³³

23. FDI in infrastructure investment is making a major contribution in a wide range of developing countries, as they privatise previously undynamic and loss-making public enterprises. Until about five years ago, privatisation in developing countries mostly concerned enterprises in the tradable sector of the economy. Recently however, privatisation has focused on infrastructure. In 1996-97, privatisation in the infrastructure sector totalled over \$50 billion, more than double the figure for the manufacturing sector.

24. This should be seen as part of the trend for the creation of global markets for the supply and private financing of infrastructure. Often, foreign investors are playing an important role in the reform and rehabilitation of developing countries' infrastructure policies and management. Areas such as energy production and distribution, water supply, public transport and telecommunications are all vital to the competitiveness of any economy and to the welfare of its people, both urban and rural.³⁴

25. Diversification of the export base is accelerated by FDI, particularly in the context of growing intra-industry and intra-firm trade across countries. This trend led by inward FDI into developing countries by multinational enterprises, can progressively spill over into a broader capacity to access foreign markets by domestic entrepreneurs. As the capacities and reach of developing countries' enterprises expand, their exports can be facilitated by establishing operations in other developing as well as developed countries, so that outward investment facilitates export growth, as it does for developed countries.

26. *Other (non-FDI) capital flows* to developing countries also supplement domestic savings and provides a diversity of financing options for the private sector. The liberalisation of financial services brings in the expertise of foreign institutions to help strengthen the capacity in developing countries to manage these flows and operate local financial markets effectively. Through the improvement of the "transactions environment" effected by the liberalisation of the capital account and financial services, the private sector can become more efficient and dynamic. These benefits from non-FDI capital flows are maximised when sound monetary and fiscal policies are maintained and there is a well-functioning private sector.

27. The composition of non-FDI capital flows to developing countries has been evolving in response to needs and conditions in different kinds of developing country, including the regulatory environment, exchange rate controls and exchange rate systems of individual developing countries. It has also been changing in response to competition and change in the global financial industry. For a long time, private capital flows from developed countries typically represented developing countries' sovereign borrowing from banks, both long- and short-term. The outbreak of the sovereign debt crisis in Latin America in the

32. *Policy Reform in India*, Development Centre (1996).

33. See Sachs and Bajpai (1998).

34. See Monod (1997).

early 1980s led to a protracted period of poor economic growth performance in that region. In emerging East Asia in the 1990s, a surge of private sector borrowing from banks and capital markets financed growing domestic private investment. In a deteriorating policy environment and with poor financial supervision and corporate governance, the declining quality of this investment contributed to the recent financial crisis.

28. To maximise the benefits of free international capital flows, it is crucial to reinforce the joint efforts of both developed and developing countries to strengthen the working of the international financial system. It is also necessary for developing countries to modernise and strengthen their financial systems, and systems of corporate governance. Well-functioning domestic financial markets and flexible product and labour markets can help reduce the cost of adjustment of the real sector in the event of adverse financial shocks.

3. Emerging market economies: achievements and lessons

29. A large number of economies have made rapid progress in economic development. In Asia, this has been led by the following emerging economies: Hong Kong, China; Korea; Singapore and Chinese Taipei; and followed by China, Indonesia, Malaysia and Thailand, and more recently the Philippines. In the 1990s, many Latin American countries have also achieved a return to economic development, after the “lost decade” of the 1980s.

30. In the East Asian emerging economies, government domestic policies have played an important role. Broad macroeconomic stability has been ensured with annual inflation rates averaging under 10 per cent, and fiscal balances mostly in surplus. Political and social stability has also been widespread, democracy has gained ground and governance issues generally are being openly addressed, although there is still an important agenda ahead for some countries in the region. In most cases, strong human resource development has been promoted, facilitating the absorption of higher technology and upgrading to higher value-added products. Even before the present financial crisis, however, a major policy challenge, especially in Thailand and Indonesia, was to improve infrastructure and the supply of skilled labour so as to ease supply constraints in the economy. And serious environmental damage in many countries had raised questions about the sustainability of economic development.

31. High economic growth and macroeconomic stability have underpinned an exceptionally high savings performance in most East Asian emerging economies. While domestic savings has thus been the major source of finance for domestic investment in these economies, capital flows have also supplemented domestic savings and contributed to strong economic performance, particularly in recent years. The recent financial crisis has, however, highlighted the importance a number of other policy requirements for restoring sustainable economic development, such as:

- Modernising and strengthening financial systems and upgrading regulatory and supervisory frameworks to encourage rigorous risk assessment and market discipline through increased disclosure and transparency.³⁵
- Reforming systems of corporate governance, competition policy and taxation, and countering bribery.
- Adopting sustainable exchange rate systems.

35. See Poret (1998).

32. For many Latin American countries, the 1980s were a watershed in economic and political development. Democratically elected governments began to replace military dictatorships. Several governments undertook far-reaching, market-oriented reforms designed to open their economies, with Chile being an early reformer and Argentina achieving progress in the 1990s. Much progress has been made in enhancing domestic competition and improving the conditions for productive investment and growth, particularly through privatisation. High growth has been achieved by those economies which have made considerable progress towards stabilisation, liberalisation and restructuring. At the same time, most Latin American countries suffer from persistent income disparities, and have a challenging agenda for human resource development. And the process of stabilising fiscal and monetary imbalances has not always been easy, as the problems in Brazil testify.

33. In short, the emerging economies of East Asia and Latin America, as well as some from Africa (such as Botswana, Ghana, Mauritius and Uganda), have demonstrated that rapid economic growth is possible. However, to achieve this, it is necessary for open trade and investment policies to be supported by mutually reinforcing domestic policy reform in the areas of macroeconomic stability, human capital, domestic competition and financial markets. A telling example is Argentina, which has managed to implement a broadly-based reform programme over the last decade, whereas it failed to sustain its attempt at trade liberalisation in the late 1970s, which was undermined by high fiscal deficits, inflation, an overvalued exchange rate and a large, inefficient state sector.

4. Can other developing countries achieve convergent growth?

34. Many of the least developed countries, generally in Africa, face very difficult conditions, such as low human capital, poor resource bases, and political instability — including civil wars and regional conflicts. Among many of the poorer countries, high growth rates of population have undermined efforts to increase the average levels of education and health. These factors have inhibited growth prospects, as have their high levels of public debt, including external debt, macroeconomic instability, poor governance and commodity price shocks (the fallout of the Asian financial crisis on commodity prices is adversely affecting the growth prospects of many African countries in the immediate future).

35. There is reason to be optimistic about the growth potential of a range of African countries if they stay the course and pursue further reform efforts (Background Briefing Note 5 on Prospects for New Emerging Economies in Africa). Indeed many African countries have been working at the same core agenda of reforms as the emerging economies of East Asia and Latin America. While there is considerable variation in the results, a number of countries have succeeded to the point where their growth rates have been considerably higher in the mid-1990s than for the two previous decades. A recent forum on African development in the context of globalisation concluded that "for Africa, there is no alternative to full integration into the global economy. Development strategies based on protectionism and state control have failed to deliver the intended results. The issue, therefore, is one of managing the transition to full integration as efficiently as possible. This includes effective protection of vulnerable groups against potentially adverse effects of the adjustment process."³⁶

36. In addition to liberalising their trade and investment policies, poor countries from Africa and other regions need to reform many areas of public policy, especially in the areas of health, education, and infrastructure. In addition, too much government spending has been channelled into defence, subsidies for loss-making and inefficient state enterprises, and into inefficient public administration.

36. Opening and Liberalization of Markets in Africa - A Response to Globalization. Development Policy Forum, German Foundation for International Development in co-operation with the German Federal Ministry for Economic Co-operation and Development and the IMF. 1-3 December 1998. www.dse.de/ef/ind1298.

37. Infrastructure is a particularly crucial issue for participation in the global economy. This includes commercial and transport infrastructure capable of interfacing with global markets with the speed and quality of service demanded. State of the art computer links are now indispensable even for very poor countries. Transport networks often require expansion, upgrading and deregulation. Africa's export competitiveness is severely undermined by high transport costs deriving in particular from the regulation of the shipping and airline industries. Policy frameworks which foster reliable power and water supplies at competitive prices are also of basic importance. Fortunately there are many new ways of approaching infrastructure provision and financing which developing countries can and are adopting to meet the large demanding requirements of the future.

ANNEX 2:

BACKGROUND BRIEFING NOTES

1. OPENNESS AND ECONOMIC GROWTH
2. INCLUSION AND EXCLUSION IN THE GLOBAL ECONOMY
3. TRADE OPENNESS, ECONOMIC GROWTH AND POVERTY REDUCTION
4. AFRICA AND ASIA: SOME COMPARATIVE GROWTH EXPERIENCES
5. PROSPECTS FOR NEW EMERGING ECONOMIES IN AFRICA
6. THE DEMOGRAPHIC CONTEXT, 1998 AND 2050 — POPULATION GROWTH AND AGE PYRAMIDS

Background Briefing Note 1: Openness and Economic Growth

New empirical studies of economic growth in developing countries find open trade policies to be a key factor in economic growth.

- The last few years have seen a flourishing of cross-country studies on economic growth in developing countries, constituting a new field of research. These studies are based on large new sets of comparable data which researchers are exploiting with considerable ingenuity. A wide range of ideas about the sources of economic growth and the reasons for the variations in developing country performance are being tested. The factors brought into the growth equation cross the spectrum from the economic to the political, sociological and geographic. This whole field of research is relatively new, with continuing debates on findings and methodologies.
- One of the main policy factors to be tested has been the openness of an economy to trade. Almost all studies are showing trade policy to be a significant explanatory factor in growth, in association with other policies, such as sound macroeconomic fundamentals and increasing political participation and stability. While separating out the independent impact of trade policy is not straightforward statistically, the significance of trade openness has been shown to hold regardless of the way in which the stance of trade policy is measured.³⁷
- In a 1995 study, the Harvard Institute of International Development compared the growth performance of developing countries with open economies and those with closed economies over the period 1970-1989³⁸. “Openness” was broadly defined to mean a decisive shift away from state-led industrialisation with high levels of protection which was the dominant development model adopted after World War II. An economy was classified as “closed” if it had any one of the following features: non-tariff barriers covering more than 40 per cent; average tariff rates of 40 per cent or more; a black market exchange rate more than 20 per cent below the official rate; a socialist economic system; a state monopoly on major exports.
- The findings for the study of a set of 89 developing countries were:

	<u>No. of countries</u>	<u>Average growth Per capita</u>
Open economies throughout 1970-1989	15	4.49
Economies not always open 1970-1989	74	0.69
OECD economies average 1970-1989	24	2.29

- The study strongly suggests that the failure of developing countries to generate convergent growth is policy-determined rather than due to low initial levels of development.

37. Edwards, Sebastian (1997), “Openness, Productivity and Growth: What do we really know?” NBER Working Paper no. 5978, Cambridge, Massachusetts.

38. Sachs, Jeffrey and Andrew Warner (1995), “Economic Reform and the Process of Global Integration”. *Brookings Papers on Economic Activity* No. 1, pp. 1-95.

Background Briefing Note 2: Inclusion and Exclusion in the Global Economy

There is a common perception that the global economy is characterised by increasing concentration of trade and investment flows on a small number of countries. Marginalisation is seen to be the fate of many developing countries in a global economy. Some striking trends and facts are often cited in support of this view. For example, the share of Sub-Saharan African countries in world trade has fallen from 3 per cent in 1976 to little more than 1 per cent in the 1990s. And 85 per cent of FDI inflows to developing countries are concentrated in only 10 countries, with China alone accounting for a large percentage.

A recent WTO study provides new light on the question of concentration of trade and investment flows. The main findings are as follows:

- Correcting concentration indices for the very large increases in world trade and investment flows shows that trade concentration has fallen over the period 1979-1995. While countries may perceive their trade share to have fallen, this is a share of a much larger pie.
- When dividing the sample of 127 developing countries into open and closed economies, the results show that concentration of trade and financial flows has fallen among open economies, whereas it has increased among closed economies.

The conclusion of this study is that marginalisation of some countries from world markets can be mostly explained by inward-looking domestic policies. Marginalisation is not inherent to the globalisation process.³⁹

Another indication of the need for a more careful look at the question of marginalisation is provided in the following table, which shows the relative importance of FDI flows to a number of developing countries in terms of their GDP. These countries are now all receiving flows of FDI which are very significant relative to their size, but very small in relation to total FDI flows to developing countries. The attention given to the size of overall FDI flows and the limited number of major recipients obscures the fact that a wider range of developing countries is benefiting substantially from FDI.

FDI inflows as a percentage of GDP, 1988-96

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Ghana	0.1%	0.3%	0.3%	0.3%	0.4%	2.8%	5.0%	4.7%	4.2%
Lesotho	0.9%	0.4%	0.4%	1.3%	0.5%	2.2%	2.5%	2.7%	3.5%
Mozambique	0.4%	0.3%	0.7%	2.1%	2.4%	3.1%	2.2%	2.7%	na
Tanzania	na	na	na	0.1%	0.3%	0.6%	1.1%	2.7%	3.0%
Uganda	na	na	na	0.0%	0.1%	1.5%	1.6%	2.0%	2.1%
Bolivia	-0.7%	-1.0%	0.2%	1.9%	2.3%	2.3%	2.1%	5.7%	6.7%
Colombia	0.6%	1.7%	1.4%	1.2%	1.8%	2.0%	2.4%	3.4%	3.4%
Nicaragua	0.0%	0.0%	0.0%	0.1%	0.8%	2.2%	2.3%	3.9%	4.6%
Paraguay	0.1%	0.3%	1.5%	1.4%	2.3%	1.7%	2.3%	2.1%	2.4%
Peru	0.3%	0.3%	0.3%	0.0%	0.4%	1.8%	5.7%	3.3%	6.2%
Laos	0.4%	0.7%	0.7%	0.7%	0.7%	2.3%	3.8%	5.8%	na
OECD average	1.0%	1.4%	1.4%	1.4%	1.1%	1.5%	1.6%	2.2%	1.7%

Source: OECD, IMF, UNCTAD

39. Low, Patrick, M. Olarreaga and J. Suarez (1998), "Does globalization cause a higher concentration of international trade and investment flows?", Economic Research and Analysis Division, Staff Working Paper ERAD-98-08, World Trade Organisation (<http://www.wto.org/wto/research/aera9808.htm>).

Background Briefing Note 3: Trade Openness, Economic Growth and Poverty Reduction

Do “openness” and economic growth reduce poverty? This has been an issue in the context of debates over structural adjustment policies. Alongside these debates there is the evidence in Asia of historically-unprecedented reductions in poverty through market-oriented outward-looking development strategies. Even in the face of the setbacks associated with the financial crises, the Asian accomplishment remains impressive.

A well-known hypothesis in development economics has been the proposition that in the growth process, the relative income share of the poorest will fall before eventually rising (the “Kuznets Curve”), even if the poor are becoming better off in absolute terms.

A new high-quality data set recently compiled by the World Bank has been the basis for the first systematic efforts at statistical testing of the relationships between growth, poverty-reduction and relative income shares⁴⁰. This data set covers some sixty developed and developing countries. While certain regions, including Africa, are not well represented, some important results are emerging.

A first result is that the Kuznet’s hypothesis is not confirmed. The World Bank compilers of the new data set found that there is no systematic relationship between income distribution and economic growth. Furthermore, they found that 77 out of 88 decade-long periods of growth were accompanied by reductions in poverty.⁴¹ And a very recent Harvard study using this data, found that overall, there is a one-to-one relationship between overall income growth and the income of the poor (defined as the poorest 20 per cent of the population). The average income of the poor tends to grow proportionately to the average income of the entire population. This is the general finding: there are some cases where the incomes of the poor grow more slowly than average incomes and some cases where the poorest gain more than the average.⁴²

There is thus now good cross-country statistical evidence of a strong relationship between overall economic growth and poverty reduction. There is also statistical evidence of a strong relationship between openness and poverty reduction, coming both from the link through a higher growth rate associated with openness, and more directly, since the policies which produce a more open economy also redress distortions which hurt the poor, especially in rural areas, and open up new job opportunities for low-income workers.⁴³

A number of interesting insights are emerging. It appears that in countries where incomes are initially fairly unequal, higher growth and openness work to reduce these inequalities, while in countries where incomes are initially fairly equal, higher growth and openness tend to make income shares less equal.⁴⁴ At

40. Deininger, K. and L. Squire (1996), “A New Data Set Measuring Income Inequality”, *World Bank Economic Review*, Vol. 10, No. 3, pp. 565-591.

41. Ibid.

42. See Gallup, J., S. Radelet and A. Warner (1998); Roemer, M. and M.K. Gugerty (1997); and Stryker, J.D. and S. Pandolfi (1997).

43. Stryker, J.D. and S. Pandolfi (1997), “Impact of Outward-Looking, Market-Oriented Policy Reform on Economic Growth and Poverty”. Discussion Paper No. 7, Consulting Assistance on Economic Reform II. Harvard Institute for Economic Development. For an analysis as to why these linkages do not work as strongly as they might, see Lipton, M. (1998), “Poverty Reduction in the 21st Century”, in *Development Issues in the 21st Century*, German Foundation for International Development, Villa Borsig Workshop Series.

44. See Gallup, Radelet, and Warner (1998). A further study on the relationship between trade policy and income distribution, using the new Deininger and Squire data set, concludes that “for the developing countries there is no evidence linking openness or trade liberalization to increases in inequality. These

the global level, growth and openness work to reduce inequality countries, because poor countries with open economies grow faster than rich countries, causing convergence in income levels among open economies.⁴⁵

Other results suggest that expenditures on health and education do most to improve the incomes of the poor in a context of strong fiscal positions and open development strategies.⁴⁶

There are countries however where the links between growth and poverty reduction are relatively weak. These are usually countries where land ownership is concentrated (as in some plantation-based economies) or where there is considerable mineral wealth. In these economies, higher growth benefits mainly the rich, and poverty reduction has to come via higher social investment targeted on the poor, which often does not materialise in such economies. Countries in Latin America, where income inequality is especially marked, are often subject to this kind of problem. It should be noted at the same time however, that some recent research has found that faster growing Latin American countries in the 80s had falling inequality, but slower growing ones had rising inequality.⁴⁷

The results of these recent studies indicate that rapid growth based on integration into the world economy through openness in trade and investment policies is necessary, even if not sufficient, for rapid poverty reduction. Supporting such policies and accompanying capacity-building is therefore a highly effective anti-poverty strategy for OECD countries to pursue. But there remains the important agenda of social investment directed towards the poor and actions to empower groups who are trapped by social, institutional or political rigidities from participating in the growth process.⁴⁸

results appear to be robust to the use of alternative trade policy and income distribution measures” [Edwards (1997b)]. There is however a question being raised in current research as to whether the skill-bias in current technological change will impact on the distribution of income between skilled and unskilled workers in developing countries. This possibility makes investment in education even more imperative. See O'Connor, David and Maria Rosa Lunati, "Economic Opening and the Demand for Skills in Developing Countries: A Review of Theory and Evidence", OECD Development Centre Technical Paper (forthcoming).

45. Sachs, Jeffrey D., and Andrew M. Warner (1995). "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity* No. 1, pp. 1-95.

46. See Gallup, Radelet, and Warner (1998).

47. See Pshacharopoulos, George, Samuel Morley, Ariel Fiszbein, Haeduck Lee, and Bill Wood (1997). "Poverty and Income Distribution in Latin America: The Story of the 1980s". World Bank Technical Paper No. 351.

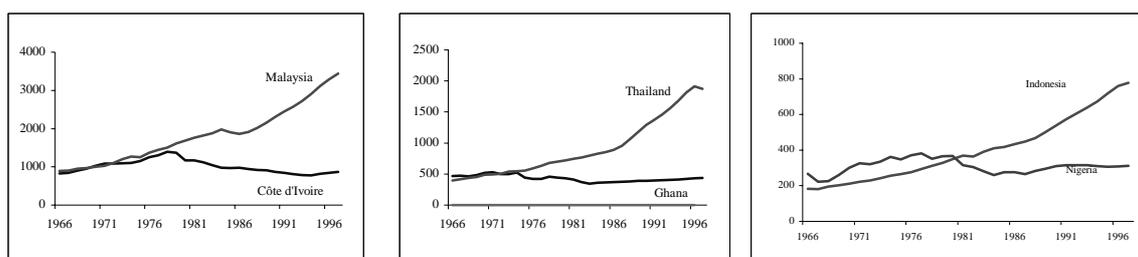
48. The Poverty Network of the OECD's Development Assistance Committee is undertaking a two-year work programme to establish guidelines for donor support for poverty reduction in developing countries.

Background Briefing Note 4: Africa and Asia: Some Comparative Growth Experiences

There are “Asian models” that can provide inspiration and guidance for Africans. They are not the models of resource and land poor North-East Asia (Korea and Chinese Taipei), or of the city states of Hong Kong and Singapore. They are the models of South-East Asia — Malaysia, Thailand and Indonesia. Three decades ago, Africa had higher income levels than these countries. Factor endowments were similar. Indeed, the South-East Asian economies competed in many of the same agricultural commodity markets, and through the strategies they adopted and Africa’s failures, they captured substantial shares in these markets from African producers.

A recent World Bank study draws out the reasons for the huge divergence in economic performance in three appropriate “side-by-side” comparative case studies — Nigeria and Indonesia; Côte d’Ivoire and Malaysia; and Ghana and Thailand. (“Practical Lessons for Africa from East Asia in Industrial and Trade Policies” by Peter Harrold et al., *World Bank Discussion Paper* No. 310, April 1996). The comparisons range over basic economic incentive structures and policy design, and institutional performance. In terms of economic outcomes, the results are captured in the Figure and Table below.

Real GDP per Capita (1987 US\$)



The fundamental conclusion of this comparative study is that two key factors – the favourable attitude to the private sector and placing the development of exports at the centre of economic strategy – were crucial in the South-East Asian countries, while on both these fronts the policy environment in the African countries was highly negative. Even after the financial crises, the current income levels of the South-East Asian countries are a multiple of incomes in the African countries.

Selected Economic Indicators for Six African and Asian Countries						
<i>Structure & Production (per cent of GDP)</i>						
	Agriculture		Industry		Services	
	1970	1996	1970	1996	1970	1996
Indonesia	45	16	19	43	36	41
Malaysia	29	13	25	46	46	41
Thailand	26	11	25	40	49	50
Nigeria	41	43	14	25	45	31
Ghana	47	44	18	17	35	39
Côte d'Ivoire	32	28	18	21	50	51
<i>Structure of Merchandise Exports (per cent of GDP)</i>						
	Fuels, Ores & Metals		Agri. Raw Material		Manufactures	
	1970	1996	1970	1996	1970	1996
Indonesia	44	32	35	6	1	51
Malaysia	30	9	50	5	7	76
Thailand(a)	15	2	25	..	8	73
Nigeria(b)	62	94	5	..	1	3
Ghana(b)	13	25	9	..	1	23
Côte d'Ivoire	2	..	25	..	6	..

Notes: (a) Data for 1996 are from the most recent available year
(b) 1991 data are shown in the 1996 column
Source: World Development Indicators, The World Bank

Background Briefing Note 5: Prospects for New Emerging Economies in Africa

After a promising decade in the 1960s, economic growth in Africa has been slow, with only a few exceptions, and per capita incomes have fallen in many African countries. While political history, geography and ethno-linguistic diversity have undoubtedly played a role, there is a basic case that with better economic policies, African countries could have grown faster.

A current OECD Development Centre research project looks at the prospects for growth in African economies up to the year 2010⁴⁹. The study:

- Establishes a growth model based on the record of 39 African economies over 1960-95.
- Identifies a core of 14 “emerging” African economies with the greatest chance of improving policies in the years ahead, located mainly in South-Eastern and West Africa.⁵⁰
- Establishes a reference group of 5 African countries that have enjoyed good policies and growth performance.

The study confirms that in Africa, as elsewhere:

- The investment rate and export growth are the two key intermediate variables behind growth performance.
- Macro-imbalances and distortions related to exchange rate management are unfavourable to growth.
- Disappointing growth has been accompanied by rising income inequality.

The study produces the following growth scenarios for the 14 core “Emerging Africa” countries during 1996-2010:

- A baseline scenario where there is no policy improvement, per capita incomes are essentially stagnant.
- A reform-based “growth bonus” where there is a burst of growth following the correction of policy distortions and macroeconomic imbalances. This adds 1.5 percentage points to per capita income growth.
- Further reforms to liberalise and facilitate trade and develop the financial sector, accompanied by investments to relieve infrastructure and human capital shortages add another 1 percentage point on average and 2 per cent over the medium term.
- With lasting reform on all these fronts and political stability, the average per capita growth rate in the 14 emerging countries reaches 4 per cent per annum. Some individual countries have outstanding growth prospects e.g. Ethiopia, 9 per cent; Uganda, 7 per cent; Mozambique, 6 per cent. Burkina Faso, Mali, Ghana and Togo also appear to have particularly good prospects.
- This “maximum growth scenario” cuts significantly into poverty levels, especially in rural areas, (indicating a potentially strong constituency for reform in rural areas) and would make the target of reducing the proportion of people living in poverty by one-half attainable in twenty years if not sooner.

49. See Guillaumont, Patrick, Sylviane Guillaumont Jeanneney and Aristomene Varoudakis (1999, forthcoming), “Economic Policy Reform and Growth prospects in Emerging African Economies”, OECD Development Centre Technical Papers Series.

50. Benin, Burkina Faso, Côte d’Ivoire, Gabon, Mali, Senegal, Togo, Ghana, Ethiopia, Kenya, Mauritania, Mozambique, Uganda, Zimbabwe.

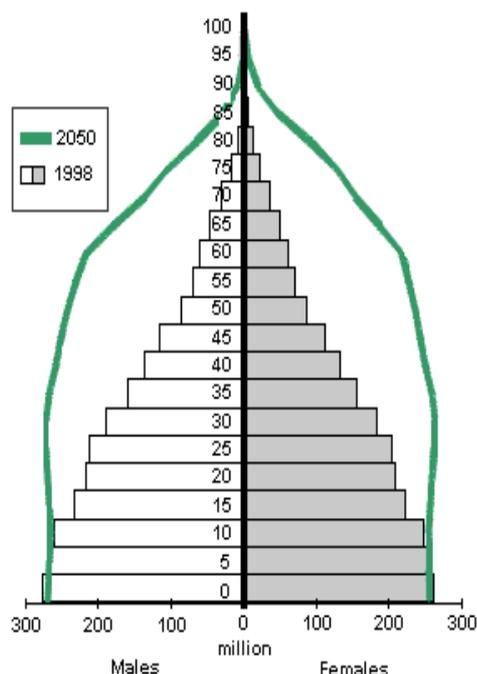
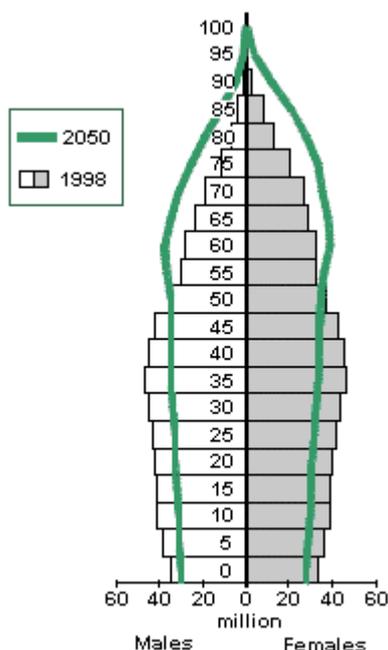
**Background Briefing Note 6:
The Demographic Context, 1998 and 2050 - Population Growth and Age Pyramids**

More Developed Regions

Total Population 1998; 1182m
 " " 2050; 1155m

Less Developed Regions

Total Population 1998; 4719m
 " " 2050; 7754m



Labour Force Growth

*Age cohort 15-60; minus 135 million
 (18% decline)*

Labour Force Growth

*Age cohort 15-60; plus 1810 million
 (64% increase)*

Source: United Nations Population Division, *World Population Prospects: The 1998 Revision*, forthcoming. (<http://www.popin.org>)

Over the last half century, there has been an unprecedented expansion in the world's population, from 2.5 billion in 1950 to 6 billion today.

In the next 50 years, the latest estimates show global population increasing by a further 3 billion, with all of this increase in the developing countries, where there will be massive expansion of people of working age. Meanwhile, in the OECD countries, population is forecast to decline and the working age population to contract.

A dramatic rise in urbanisation is also changing the economic, social and spatial shape of most developing countries, as their economic structures move toward industry and services. The urban population of less-developed countries may increase from one-third in 1990 to over 50 per cent by 2020, with a large rise in the number of megacities, particularly in Asia.

Mastering the challenges inherent in this demographic revolution will require a high level of performance in economic, social and political systems worldwide.

The weight of developing countries in world trade and investment will increase hugely, adding importance to their interests in, and commitment to, a rules-based world economy.

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