



Policy Coherence of OECD Countries Matters: Evidence from East Asia

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The East Asian development experience is still not well understood – especially the region’s clustered, sequential development process and neighbourhood effects linking economies at different levels of industrial development. Until now, the development impact of OECD-country policies had never been analysed systematically from this perspective. How have different policy vectors transmitted by OECD countries, notably in the areas of trade, investment and aid, contributed to the development of the region? To what extent have the impacts of OECD country policies depended on the capacity of East Asian economies to respond through their own public policies? This note sketches out the main storylines of what has happened to East Asia over the past decades, particularly since the mid-1980s, through the lens of OECD countries’ “policy coherence for development” (see Box). It then recaptures major development lessons from East Asia and highlights key policy challenges for OECD countries.

East Asia’s Clustered, Sequential Development Process

The development experience of East Asia throughout most of the post-war years is such that a number of economies in the region have managed in a sequential fashion to achieve historically high growth rates of per capita GDP – typically 4 to 6 per cent per annum or even higher in some cases – for a significantly long period. Starting from Japan in the 1950s and 1960s, the region’s growth dynamism has continued apace since the 1970s,

with the ascendancy of Asian newly industrialising economies (NIEs: Chinese Taipei, Hong Kong, Korea and Singapore), followed by several Association of Southeast Asian Nations (ASEAN) economies (Indonesia, Malaysia, the Philippines, Thailand and most recently, Viet Nam) and China. It should be stressed at the outset that the region’s rapid economic growth has been accompanied, with few exceptions, by significant reductions in absolute poverty and noticeable improvements in social conditions, such as life expectancy, infant mortality and literacy.

East Asia’s success in achieving high per-capita growth rates during the period concerned is primarily a result of successful industrialisation. The process comprises a clustered, sequential industrialisation, accompanied by a rapid rise in the share of manufactures in total merchandise exports, as the economies of the region become more open and develop. First, industrialisation started from labour-intensive sectors with small capital requirements, moving up to capital-intensive sectors, such as heavy and petrochemical industries, and then to technology-intensive sectors, like machinery and electronic industries. This sequencing of industrial development with shifts in leading industries in an economy during a particular period of time is often called the “flying-geese pattern”. Second, East Asian industrialisation was sequential in that as a group of economies upgraded their industry from labour-intensive sectors to capital-intensive sectors and then to technology-intensive sectors, another group of countries followed a similar pattern. As the second group achieved higher levels of industrialisation, the next tier of countries

Box – OECD Horizontal Programme on Policy Coherence for Development: A Regional Case Study on East Asia

The OECD 2002 Ministerial Meeting issued a statement on development, calling upon the OECD to “*enhance understanding of the development dimensions of Member country policies and their impact on developing countries*”. The OECD has responded to this ministerial mandate by launching a horizontal programme on policy coherence for development. Its main task is to facilitate and support efforts of both OECD and developing countries to encourage the systematic promotion of mutually-reinforcing policy actions, including aid but extending beyond it. The types of OECD country policy interactions that may affect development outcomes include, *inter alia*, those resulting from the interplay of policies in the fields of agriculture, trade, investment, migration and aid.

Issues drawn from specific country and regional cases can provide the most meaningful, concrete information on the development implications of OECD country policies. A first regional case study focused on East Asia, with special reference to the region’s development experiences in the post-war years, especially since the mid-1980s. The links between the region’s developing and transition economies and major OECD countries are strong, not only through the international exchange of goods and services but also through international flows of capital, technology and labour. The East Asian region is, therefore, of particular interest from the standpoint of the development impact of OECD country policies.

After all, East Asia’s development experience has shown that growth, poverty reduction and even “graduation” – Japan and Korea acceded to the OECD Membership in 1964 and 1996, respectively – are possible in the developing world, provided one embraces appropriate policies in an enabling international economic environment. Perhaps not surprisingly, most of these “miracle” economies have strongly rebounded from the financial and currency crises that badly hit the region in 1997-1998. Nonetheless, they face several new development challenges. Poverty reduction remains at the top of the policy agenda, as the East Asian region still includes several least-developed, low-income countries as well as transition economies, with a significant number of the world’s poorest people. Furthermore, the devastating effects of the Tsunami of the closing days of 2004 have hit the poorest segments of the population hardest of all, posing major additional development challenges to the region.

emerged to catch up with the forerunners. For example, Japan had achieved high levels of industrialisation by the 1970s: the Asian NIEs (Chinese Taipei, Hong Kong, Korea and Singapore) were the first group to follow Japan; the middle-income ASEAN countries were the next to follow the Asian NIEs; and China is the last economy to catch up with – and significantly challenge – the ASEAN economies. While the “flying-geese” metaphor captures the regional patterns of industrial development quite nicely, it does not necessarily explain what made such clustered, sequential industrialisation possible. The question is even more important given that not all countries were part of the cluster.

OECD-Country Macroeconomic and Technological Vectors

Several developing economies of East Asia simultaneously experienced major turnarounds in their catching-up growth process in the early 1970s and again in the mid-1980s. Behind the region’s clustered, sequential development process, there were indeed significant changes in the international economic environment. In terms of macroeconomic policy developments, easy monetary policy among OECD countries in the 1970s led to low real interest rates, and the Asian NIEs found it convenient to finance their strong investment demand by borrowing petrodollars recycled through banks in London and New York. Relocation of labour-intensive manufacturing sectors among East Asian economies was also facilitated by a successive round of the yen’s real effective appreciation, particularly in the wake of the Plaza

Accord of the dollar-yen currency realignment in September 1985. In the early 1990s, real interest rates in the United States and other OECD countries were once again low so that international capital went to East Asian (and other emerging) economies to earn higher returns. Thus, external macroeconomic factors, such as movements in interest rates and exchange rates among major OECD countries, have exerted an important impact on the East Asian economies through trade and financial linkages.

The 1970s also marked the beginning of what is now called the “microelectronics revolution”. This helped both revitalise mature industries through the development of labour- and energy-saving technologies (e.g. numerically-controlled machine tools, robotics, compact cars) and also develop electronic, computer and other high-tech industries. One of the major consequences of these technological and industrial developments is the growing importance of intra-product specialisation in manufactured trade. While trade in parts and components (as opposed to final products) is hardly new, its share in total trade has risen significantly in East Asia. If the stages of a production process are physically separable, the manufacture of a product is amenable to fragmentation so that the various stages of production can be spatially separated and undertaken at different locations where the costs of production are lowest with the best mix of technologies. Although spatial dispersion of production processes across countries usually entails the costs of communication, co-ordination and logistics as well as other trade costs due to restrictive trade policies and practices, recent advances in telecommunication and transportation technologies and reductions in trade and investment

barriers have substantially reduced the trade costs and thus stimulated fragmentation of production processes across national borders.

These macroeconomic and technological developments emanating from OECD countries and their policies have facilitated East Asian economies' entry into the network of global production sharing and establishment as viable competitors in world markets. The economic ascendancy of four Asian NIEs during the 1970s can be seen as the harbinger of a promising growth model. Most of the literature on East Asia's development experience has given focus to the question of how domestic policies and institutions in individual economies were growth-generating (as in the case of the World Bank Report – *the East Asian Miracle* – published in 1993) but did not pay adequate attention to the question of how growth stimuli and incentives were generated and transmitted from more advanced to less advanced economies in a particular region. The effectiveness of growth-promoting policies at the individual economy's level depends critically on how well and how quickly each economy can respond to and exploit the external policy environment and opportunities by means of its own public policies.

The Trade-FDI Nexus

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

Nonetheless, the role of FDI for East Asia's clustered, sequential growth has been quite diverse among the economies of the region; some have relied more on FDI than others. For those economies, such as Hong Kong, Singapore, Malaysia and more recently, China and three new members of ASEAN (Cambodia, Lao PDR and Viet

Nam), FDI inflows have become increasingly important for their economies. This is in sharp contrast with the experience of Japan, Korea and Chinese Taipei in the 1970s and 1980s, as these economies relied much less on "FDI as a package" and more on licensing arrangements as a means of importing foreign technology. It is only quite recent (particularly, after the 1997-98 crisis) that the FDI stock-GDP ratio has started to rise markedly in Chinese Taipei and Korea, as these economies have eased restrictions or taken measures to encourage FDI inflows.

The Role of International Aid

International aid has supported East Asia's post-war development process and in particular, the region's emerging trade-FDI nexus, through concessionary financing for economic and social infrastructure construction and technical assistance for human and institutional capacity building. While its precise impact on development cannot be easily measured, East Asia has benefited from the range of official development assistance (ODA) programmes offered by the donors. Several successful cases of ODA programmes, including infrastructure development projects in ASEAN countries, such as the Brantas River Basin Management Project in East Java and the Eastern Seaboard Development Plan in Thailand, have been well documented. During and after the 1997-98 economic crisis, there was renewed interest in ODA in East Asia, with a major shift in priorities towards "social infrastructure" (e.g. education, health, water and other social services) by all donors, in particular by Australia, EU member countries and the United States. It is also worth noting that, in value terms, Japan accounted for more than one third of total ODA commitments for social infrastructure in the region over the period 1997-2002, though the relative importance of this sector remains modest in Japan's ODA. International aid can also help the recipient countries, through policy dialogue and consultation, to strengthen their capacity to formulate and implement their own development policies. Again, such impacts are even more difficult to measure, but some anecdotal evidence regarding China's reform experience in the 1980s points to the usefulness of policy dialogue and interaction between the donor community and the recipient country.

This is not to say that international aid in East Asia is free from problems and criticism. To the contrary, international aid has been subjected to a host of public pressures over the last decade. One source of such pressure comes from the increased desire on the part of recipient countries themselves to improve domestic governance in relation to international aid. For instance, criticisms have been levelled at social dislocations and environmental damage caused by large-scale infrastructure projects in some recipient countries. Another concern has been raised over

the changing needs of international aid, as the recipient economies develop. Pressures also arise from the domestic front of many donor countries, due to their budgetary constraints on foreign aid. Although the pressure to cut back aid money appears to have somewhat subsided in the aftermath of the 1997-98 crisis, the fundamental question remains as to what role international aid in East Asia should play in the future. This is particularly important for the reform of ODA policy and management in donor countries, especially Japan as the top bilateral donor in the region.

The 1997-98 Crisis

The rapid growth of several East Asian economies since the mid-1980s, enhanced by their financial opening and exchange rate pegs, led to large inflows of private capital in the mid-1990s. Fuelled by such capital inflows, private credit booms created pre-crisis vulnerabilities in the region. A greater availability of international private funds was considered a "good thing" for development, since this was potentially welfare-increasing in recipient countries. However, greater financial integration made their economies more vulnerable to a sudden change in the investors' sentiment and external economic environment, such as international interest-rate shocks. The experience of several East Asian economies in the early 1990s suggests that difficulties in managing large capital inflows was a critical policy issue for macroeconomic management at that time, as these economies were running at near or full capacity (IMF 1995). Indeed, heavy capital inflows became disruptive for countries such as Thailand, as they led to a real appreciation of the currency, heightened inflationary pressures through increased money supply, and widened the country's current-account deficits to an "unsustainable" level.

The major causes of the 1997-98 crisis can be summarised by pointing out three common forces that interacted with each other to leave these economies vulnerable to external shocks: *i*) ready availability of private capital, especially short-term capital; *ii*) macroeconomic and exchange-rate policies that permitted capital inflows to fuel a credit boom; *iii*) newly liberalised but insufficiently regulated financial systems. While the Thai stock market had already declined substantially during the first half of 1997, a trigger to the crisis came when the government yielded to the repeated attacks against the baht and abandoned the peg on 2 July. The financial and currency crisis of Thailand developed into a region-wide crisis, as contagion spread to Indonesia, Malaysia, the Philippines, Korea and other economies of the region by causing a sudden huge outflow of capital and a simultaneous fall in asset prices.

In addition to its associated detrimental social effects, the economic consequence of the 1997-98 crisis was a

heavy blow to the economies of the region in terms of the fiscal cost of bailing out and reconstructing the financial sector and the output foregone due to the historically worst ever recession that ensued. Moreover, there was some concern that the social impact of the crisis may have a lasting effect on the economy over the longer term. Such concern has drawn greater attention to the question of social cohesion and domestic governance in East Asian societies.

The Dynamics for Another Miracle

There are reasons to believe that East Asia will continue to lead the world as the most dynamic growth centre. Over the past years East Asian economies as a whole have demonstrated remarkable resilience to multiple shocks, such as the bursting of the high-tech bubble and a recession in major OECD countries, high and volatile oil prices, jitters of terrorism and the Iraq War and the SARS epidemic. Part of the resilience is due to the support that came from OECD countries like Japan, as well as the fact that OECD countries kept their markets open to East Asian trade during the time of crisis. Moreover, new growth dynamics are at work in the region, including the ascendancy of China (and India in neighbouring South Asia) and the emergence of new players, such as Viet Nam, the rapid growth in intra-regional trade, and a coming of age of the Asian consumer in terms of greater sophistication and purchasing power.

In considering the question of whether East Asia can achieve another miracle of clustered, sequential growth over a sustained period, there are at least three issues to be addressed. First of all, it is important to design necessary domestic policies and institutions so as to ensure that the benefits of economic growth are more broadly and equitably shared within the society. Although many East Asian economies have been successful in alleviating extreme poverty over the past decades, it has proven to be more difficult to reduce income inequality. The recent natural disaster is magnifying the pressures in this respect. Designing effective social sector protection is a major challenge for this purpose and the experience of relatively advanced economies of the region (e.g. Chinese Taipei and Korea) may provide useful lessons. A second major issue is that FDI flows into ASEAN have slowed down in recent years relative to those into China. Middle-income ASEAN countries – Malaysia, Thailand, Indonesia and the Philippines – are now facing the major challenge of improving their attractiveness as hosts to FDI in a rapidly changing economic environment. To remain attractive and competitive, the ASEAN economies need to maintain FDI-friendly climates, continue to upgrade human capital, and move on to a technological – rather than a factor-intensive – mode of production by shifting to a knowledge-based economy.

In addition, the ASEAN economies need to implement the ASEAN Free Trade Agreement (AFTA) by eliminating the often long exclusion lists so as to be able to enjoy a larger market and economies of scale. Third, several low-income countries – such as Cambodia, Laos and Myanmar – have been “left behind” or are in any event less successful in participating in the region’s multilayered, sequential development process. Institution-building for economic development and progressive poverty elimination in these countries should be of the highest priority. An important policy question is how ODA programmes can be more directly linked to trade and FDI through their emphasis on promoting infrastructure development. One of the key lessons from the experience of East Asia’s sequential development is that Japan and other advanced East Asian economies have regarded outward FDI in the less advanced economies of the region as part of industrial restructuring necessary to move up technological ladders and to shift domestic resources to more efficient uses. Now, the roles not only of these advanced economies but also of middle-income countries are becoming increasingly important to keep this dynamic process moving.

Key Coherence Lessons from East Asia

The East Asian economies were able to stimulate and benefit from a powerful trade-FDI nexus due to their market-friendly policy environments (good investment climate) and their institutional and human capability to absorb foreign capital. They could use such opportunities to expand exports and imports for industrialisation and development. With manufactured trade, FDI and ODA, the developing economies in East Asia were in a position to benefit from the positive impact of strong policy coherence in terms of growth stimuli and incentives transmitted from more advanced to less advanced economies in the region. However, coherence was prominently weak in the agricultural policy area. During and in the aftermath of the 1997-98 crisis, several ASEAN countries, most notably Thailand, rediscovered that the agricultural sector played an important role in sustaining export earnings and rural household income and absorbing displaced workers, thereby contributing to economic recovery and political stability.

The impact of the OECD-country agricultural policies on growth and poverty reduction may differ significantly across developing economies within the region. In the case of commodities, this critically depends, among others, on the extent to which the policies in question are affecting world prices, the extent to which the domestic agricultural sector in East Asian economies is linked to those commodity markets and some other structural and institutional characteristics of their own economies. For example, it has been argued that the effects of rice and sugar policies

in OECD countries on poverty reduction efforts in the East Asian economies are likely to be more substantial in Viet Nam than in Indonesia. In Indonesia, there is so much integration in the labour market that rural wage rates are largely exogenous to the rural and agricultural sector. It is less likely to be so in Viet Nam. Given that the rural labour market is less well integrated with the urban labour market, lower agricultural prices (caused by OECD-country agricultural policies) are likely to have a depressing effect on agricultural wage rates, thereby having a more direct impact on rural poverty. In the case of processed products, OECD policies like tariff escalation and non-tariff barriers may be curbing the development of food industries that could become significant sources of employment, value-added and scientific advances. This analysis highlights the importance (and added value) of comparative country case studies in policy coherence research.

Challenges Ahead for Policy Coherence in OECD Countries

The East Asian experience has shown that this set of successful and indispensable policy variables needs to be both enabled and reinforced through OECD policy stimuli and support. OECD countries play at least five essential roles in fostering policy coherence for development. These roles are to:

- ◆ Help maintain security and political stability, which are fundamental to the long-term growth, development and poverty reduction in developing economies;
- ◆ Get the macroeconomic policy framework right, to avoid unintended policy shocks and create an enabling external environment conducive for private sector-led growth in developing economies;
- ◆ Promote an open and predictable international marketplace for goods and services on a multilateral and non-discriminatory basis, as well as orderly movement of people, complemented by trade-related assistance;
- ◆ Strengthen the governance structure on international investment and finance to facilitate the flow of capital and technology into developing economies and help maintain financial stability; and
- ◆ Increase the effectiveness of aid, by both bilateral and multilateral donors, through aid co-ordination and partnership and with a focus on economic growth and capacity building, both human and institutional.

Security and political stability are fundamental to long-term growth and poverty reduction in developing economies. A key challenge is to find appropriate instruments through whole-of-government approaches to build confidence and prevent conflict in major developing regions. In East Asia, the role of OECD countries in promoting the region’s political and security co-operation deserves particular emphasis. In this regard, the ASEAN Regional Forum (ARF),

currently including the participation of all ten ASEAN countries, seven OECD Member countries (counting the European Union as one) and five other countries (including China, India and Russia), has also played an increasingly important part as an instrument to foster constructive dialogue and confidence building on political and security issues of common interest and concern in the Asia-Pacific. In some other parts of the world, until recently, OECD country policies may not have been sufficiently attune to the problems of unstable, insecure "fragile" states and the interrelated, coherent policy responses they demand.

It is impossible to consider policy coherence for development without paying due attention to macroeconomic linkages, which have become all the stronger during the past two decades. In current circumstances, particular attention needs to be paid to the challenge of correcting global current account imbalances among North America, Europe and East Asia, without inducing excessively large exchange rate changes or economic disruptions. Developing countries stand to gain most if OECD countries can promote, over the medium term, policies designed to achieve the highest sustainable rates of economic growth and employment, while at the same time refraining from protectionist measures at the border.

Improving market access for the products and services of major interest to developing-country exporters must be complemented by necessary policy reforms and capacity building efforts on the part of developing countries, notably the least-developed. International assistance can and should play an important, facilitating role in helping them to strengthen the domestic supply response to the emerging market opportunities and challenges in an increasingly open trading environment. Trade-related assistance constitutes a salient component of "the coherence package" OECD countries can offer to make trade work for development.

Governance issues related to international investment and finance in East Asia have come into play at the national, regional and international levels. The OECD as a guardian and promoter of international investment instruments can play a significant role at both national and regional levels. A key challenge is to strengthen existing channels and find new ones necessary to transmit this important unfinished agenda into concrete policy actions.

As regards the last point, it may be worth reiterating that the reforms necessary to achieve development goals should be home-grown and such reform efforts can be supported by international aid. East Asia's development experience strongly supports this view. Many East Asian economies have made *unilateral* efforts to strengthen productive and trade capacity so as to respond effectively to market opportunities and challenges. The economic ascendancy of the world's two most populous countries, China and India, makes this task even more urgent. Donors have been called upon to help them in this regard.

On the other hand, East Asian economies have also learned from the 1997-98 fallout that it is equally critical to manage financial risk and protect the poor and vulnerable more effectively. This requires their governments to strengthen the banking and corporate sectors, while at the same time improving social safety nets and establishing a good working partnership with civil society. Once again donors have been called upon to assist them. Donors will face a long list of priority sectors for development assistance; this is where the question of aid co-ordination comes into the picture.

Despite the enormous progress of several East Asian economies and more recently, China, the circumstances of the region's poorest countries that are still highly dependent on a narrow range of commodity or manufactured exports call for special OECD country attention. Capacity building efforts to position their supply side so as to benefit from globalisation and greater openness in the regional market are of high priority. While regional and broader south-south co-operation is likely to gain importance in the coming years, their dependence on OECD countries for mutually-reinforcing, coherent policies will remain significant. For example, a more strategic use of ODA to help them overcome their unfavourable conditions is warranted. There is an urgent need to strengthen human resource development through greater investment in education and vocational training for skill upgrading. A focus on agriculture and rural development is also essential to reduce poverty and inequality. At the same time, OECD countries are required to make further efforts to bring down trade barriers and enhance market access to imports from these developing countries.

The DAC/OECD regularly conducts a peer review of its member countries' aid policies, which involve discussions on policy coherence. Such peer reviews currently focus mainly on institutional aspects, including anecdotal illustrations of coherence issues. There are several ways in which this process could be constructively enhanced to obtain greater "buy-in" from policy communities outside of development policy makers in national capitals. One approach would be to apply an analytical framework, drawing upon key elements emphasised in this study and others, to the peer reviews on a systematic basis. Second, a periodic comparative monitoring report involving several OECD Committees in its review could be launched. A third approach could build upon the experience with the joint Mutual Review of Development Effectiveness to be discussed in early 2005 by NEPAD and OECD Heads of State and Ministers as a model for similar dialogue with other partner countries. Analysis and case studies provided by partner countries should be an integral part of the process. A key challenge for OECD countries is to improve and broaden this peer and mutual review function with a view to enhancing whole-of-government accountability in economic policy-making for development.

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