The Development Dimension

Fostering Development in a Global Economy

A WHOLE OF GOVERNMENT PERSPECTIVE

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié en français sous le titre :

Encourager le développement dans une économie mondiale

POUR DES POLITIQUES COHÉRENTES

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FOREWORD

Sustaining global economic growth and actively sharing its benefits will further the interests of all countries, developed and developing alike. No country should be excluded from reaping the economic advantages of the increasingly integrated global economy. Recognising this, the international community has joined forces in committing to the Millennium Development Goals (MDGs) and to the global partnership enshrined in the Monterrey Consensus.

As part of the global partnership based on mutual accountability, OECD member countries have resolved to increase the coherence between their domestic and foreign policies in support of the development goals to which they have all committed. In 2002, the OECD Council at Ministerial level called upon the OECD "to enhance understanding of the development dimensions of member country policies and their impacts on developing countries". The Ministerial statement foresaw the multiple policy strands that need to be woven together to achieve a coherent approach (see Annex A).

This introductory volume seeks to increase the knowledge of the impacts of OECD country policies on development – *the development dimension* of policies – and suggest how greater coherence between policies can enhance development progress. It answers the fundamental questions of what policy coherence for development means; what its objectives are; what levels of decision making are involved; what specific coherence issues are at stake; and why more coherent policies are increasingly important in the self-interests of OECD member countries.

This publication takes up the pressing issues of coherence between trade, agriculture, migration and aid policies. It also emphasises that policy coherence today cannot ignore macroeconomic and financial interdependence. It clearly lays out the implications and challenges arising from the emergence of new major economic players, intensified financial integration, and foreign exchange and reserve policies. It discusses imbalances in the international financial architecture and assesses the implications of various proposals – currently under consideration – on capital flows to developing countries.

In addition, this first publication in *the development dimension* series analyses why some OECD member countries give higher priority to development assistance

and the policy coherence agenda than others, examining some of the political correlates that come into play. It finds that efforts to quantify and assess the achievement of policy coherence to date, including efforts by various organisations and agencies, have been inadequate. In this largely unexplored area, it proposes concrete evaluation approaches, methods and governance, and concludes with a specific proposal to evaluate the OECD's efforts in promoting policy coherence for development in accordance with its Ministerial mandate.

The essays brought together in this volume have been prepared under various components of the OECD's programme on policy coherence for development, which is funded through voluntary contributions. The OECD secretariat expresses its appreciation to the governments of Canada, France, Ireland, Japan, the Netherlands, Norway, Sweden, Switzerland and the United Kingdom for their support.

Acknowledgements

Appreciation is also extended to the nine authors whose work is presented in this volume: Ricardo Gottschalk, Martin Grandes, Stephany Griffith-Jones, Ethan Kapstein, Robert Picciotto, Nicolas Pinaud, Richard Pomfret, Helmut Reisen, and Andrew Rosser. The chapters have been prepared for different components of the OECD's project on policy coherence for development, co-ordinated by Alexandra Trzeciak-Duval. She has edited this volume with the editorial and production assistance of Julie Harris.

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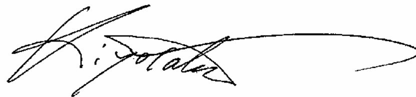
PREFACE

The intensification of global interdependence calls for a better balance in the international governance system, and for heightened attention to be paid to the trans-border impacts of national and regional policies. Improving international governance and addressing policy spill-overs are in the mutual interests of developed and developing countries alike, but will require political "give and take".

At the OECD we are developing a strategy to address our own membership and governance challenges, thereby contributing to a rebalanced international governance structure. We are also helping our member countries as they look for ways to take into account the impacts of their policies on the rest of the world. Many of them have put into place institutional mechanisms to facilitate this. Taken together, these efforts will ultimately result in greater policy coherence in support of the internationally agreed development goals.

Because achieving greater coherence between policies with development objectives is a complex and politically difficult undertaking, some dismiss the very concept. On the contrary, what the OECD seeks to do, in response to our Ministerial mandate, is to "un-bundle" the notion of coherence so as to make it better known, understood and actionable. Politicians, decision makers and analysts need more analytical information about the consequences of policy on development in order to be able to rebut the arguments of those with vested interests in preserving the *status quo*. In this collection of essays, the concept of policy coherence for development is defined and illustrated through a range of examples. The realities of the political environment are openly discussed. The issues and challenges of growing macroeconomic interdependence and financial integration are analysed, with their implications for policy formulation and policy mix.

In this volume, and in those to follow as part of a new series, called **The Development Dimension,** the OECD seeks to analyse the development aspects of policies in specific domains. Be it coherence between development objectives and macroeconomic, financial or trade policies, which are dealt with here – or in relation to institutional, agricultural, fisheries, migration, environmental or other policies, which will be treated in subsequent volumes – the OECD proposes to explain both policy trade-offs and policy synergies. We aim to raise awareness, provide the analysis, and offer policy options. By systematically taking *the development dimension* of member country policies into account, OECD analysis and dialogue can help change behaviour in support of development in an ever more integrated, interdependent global economy.



Kiyo Akasaka
Deputy Secretary-General
OECD

INTRODUCTION

KEY CONCEPTS, CENTRAL ISSUES

By Robert Picciotto[1]

> Coherent policies for development … cannot be mandated by the development community. But we have both a need and a responsibility to ensure that the development dimension is indeed fully understood and taken into account, since if it is not, much of our spending will be merely offsetting the costs imposed on our partners by other policies of our own governments.
>
> Richard Manning, Chair, OECD Development Assistance Committee

The achievement of internationally agreed development objectives requires policy coherence. The purpose of this book is to clarify options, stimulate reflection, and facilitate debate among the diverse groups that have a stake in the topic of policy coherence for development (PCD). This introduction presents the key underlying concepts of PCD, in terms of both institutional economics and governance, and unpacks the notion into four dimensions of coherence. It recalls the central issues that OECD Ministers had in mind in mandating work on PCD and sets out the main topics to be examined in the chapters to follow.

The limits of coherence

A principled search for policy coherence is integral to good governance, but it cannot eliminate all inconsistencies. A better understanding of this concept is necessary. What then is "coherence"?

In physics, the term refers to the force by which molecules are held together, the "constant phase relationship" of waves or the viscosity of a substance. In philosophy, coherence theory holds that "the truth of a proposition consists in the coherence of that proposition with all other true propositions". These are precise concepts. By contrast, in the social sciences, the term is new and untested (Hoebink,

2001). Unlike "convergence", a well-defined economic hypothesis, "coherence" has not found its way into standard textbooks or reference documents.

Dictionaries[2] define coherence as "the action of sticking together" or "the quality of being logically integrated, consistent and intelligible". The term has wholesome connotations. It evokes logic, consistency and constancy of purpose. Thus, in public affairs, where common usage prevails, coherence is highly prized: voters interpret lack of coherence as weakness, indecision or opportunism. But in the "give and take" of politics, coherence is, at best, an elusive goal: diverse interests must be weighed and multiple goals pursued.

Indeed, Professor L. Alan Winters (2000) has observed that the "here" in policy coherence is hard to find since, more often than not, policy has multiple dimensions – and uncertainty prevails about the links between policy levers and policy impacts. In the real world, politicians strive to construct a working consensus among diverse interests in uncertain operating environments. Necessarily, this means settling for second- or third-best solutions and striking a balance between conflicting goals, *i.e.* imperfect coherence from the perspective of a single policy objective.

Equally elusive is the avoidance of self-contradiction and minimisation of change over time (also implied by coherence). Unexpected events, third-party intervention or shifts in opinion frequently induce shifts in policy stances. Thus, in the regular conduct of public affairs, the principle of coherence is observed mainly in the breach. The more complex and volatile the operating environment, the more open the society, the greater the chances that many goals have to be pursued in parallel, diverse constituencies placated and new challenges faced as conditions evolve.

In order to be integrated into policy design, action and evaluation, therefore, the coherence concept is meaningful only when combined with clearly defined goals. Also helpful are specified decision protocols and agreed implementation plans. But even where there is no ambiguity regarding the policy goal(s) one seeks to cohere about (*e.g.* a specific poverty-reduction target), a programme to implement the goals may not have been defined. There may be no consensus for action among stakeholders due to conflicting worldviews, divergent interests, or lack of evidence about how best to go about achieving results.

Ambiguity about plans may even be deliberate and promoted by some participants. For example, many developing country policy makers and non-governmental organisations (NGOs) are ambivalent about the concept of coherence in development assistance since they fear that harmonisation among donors could facilitate imposition of inappropriate policy standards on aid recipients. At the tenth

United Nations Conference on Trade and Development (UNCTAD X), the Indian Minister of Commerce warned: "we should be careful that in the name of coherence we do not create a networking behemoth which puts pressure on developing countries through cross-conditionality" (Global Policy Forum, 2003). Sound theoretical arguments underlie this concern.

The theory of coherence

Absolute policy coherence implies that the preference functions of diverse groups can be aggregated without ambiguity. But economic theory demonstrates the exact opposite: majority rule leads to outcomes that depend less on preferences than on agenda setting and the sequencing of votes (Arrow, 1963). Kenneth Arrow's "impossibility theorem" demonstrates that under plausible assumptions, only absolute and competent dictatorships operating in stable environments can achieve full and consistent policy coherence. Subsequent research has probed the instability of voting coalitions, the mechanics of vote trading and logrolling and the rationale of partitioning rule making to achieve equilibrium.

In order to reach consensus, dilemmas of collective action must be resolved. They are most intractable within large groups (due to free riding) – hence, the rationale of committees or departments with jurisdictions over specialised domains. But breaking out complex issues into manageable segments encourages a "silo" approach to policy making. As a result, coherence within a specialised group may be secured at the expense of incoherence across groups. This is such a frequent occurrence that policy coherence is often equated with a "whole of government" approach.

Such an approach requires transparent information links among individual departments as well as strong leadership and transparent linkages between the specialised units and the sovereign body. But even after coherent policy goals have been set and clear outcome indicators have been selected, a choice must be made between alternative courses of action. Such choices are usually constrained by imperfect information, time pressure and limited capacities for analysis.

In such circumstances, theory tells us that optimisation is likely only if the information and the analytical resources required to achieve it are free.[3] Conversely, according to the "rational ignorance" doctrine, apparently incoherent behaviour is explained by information asymmetries, data processing costs, and attitudes to risk. Equally, coherence of outcomes cannot be guaranteed *ex post* even when it has been secured *ex ante*: sound policy design does not necessarily lead to coherence in

implementation since in the real world a variety of obstacles may stand in the way of achieving results.

The above foray into the institutional economics of coherence confirms that its realisation requires careful delineation of policy goals, objective assessments of decision-making structures and effective management of the sundry programmes associated with policy implementation.

The governance dimension

Pervasive incoherence in government decision making undermines public trust, creates uncertainty, contributes to social tensions and creates waste. The same consequences arise at the international level, aggravating mistrust and frictions between societal groups and countries. Appropriate measures of coherence constitute legitimate tests for public policy and programmes.

In a democracy, citizens need not tolerate *unnecessary incoherence*, *i.e.* decisions that are inefficient from a social welfare perspective in circumstances where "win-win" outcomes are demonstrably feasible. On the other hand, for sound theoretical and practical reasons, achieving coherence fully and in all circumstances is not feasible. Coherence in public affairs is an ideal well worth striving for. Clarity of objectives and rigorous analytical underpinnings for alternative courses of action are critical.

On the one hand, *unintended* incoherence may occur because of factors outside the control of those in authority and incoherence may be *intended* and even *necessary* to achieve acceptable outcomes (*e.g.* where trade-offs are made to accommodate conflicting goals). On the other hand, incoherence may result, not from principled disagreement on the direction to pull or from uncertainty regarding the links between policy means and goals, but simply because of ignorance, incompetence, corruption or capture by vested interests.

From an accountability perspective, the bottom line is that policy makers who choose unnecessary incoherence – either unintentionally, *e.g.* if they are uninformed and/or incompetent, or intentionally, *e.g.* when they decide to favour the few at the expense of the many – should be censured. During the Watergate hearings, Senator Howard Baker asked "What did he know? And when did he know it?" Both questions arise every time a politician makes a decision that has a direct or indirect impact on public welfare.[4] Consistency between what a decision maker knows (or ought to know) and what he/she decides to do is an integral part of coherent decision making. Thus, when done with tolerance and discernment, the pursuit of policy

coherence is a worthy endeavour. Public accountability means congruence between what is known about how to achieve the common welfare and what those in authority choose to do to achieve it.

In sum, good governance[5] implies transparency in decision making, evidence-based policy formulation and independent monitoring and evaluation which assess how the major agents involved in policy making and implementation fulfil their reciprocal obligations; consider the alternatives open to them; reach the decisions they do; and follow up with appropriate implementation arrangements. This helps to draw critical distinctions between intended *versus* unintended incoherence and necessary *versus* unnecessary incoherence – both when policies are designed and also when they are put into practice.

The PCD mandate

The PCD mandate is unambiguous: the Ministerial Statement entitled *OECD Action for a Shared Development Agenda* calls on the OECD to "enhance understanding of the development dimensions of member country policies and their impacts on developing countries. Analysis should consider trade-offs and potential synergies across such areas as trade, investment, agriculture, health, education, the environment and development co-operation, to encourage greater policy coherence in support of the internationally agreed development goals" (OECD, 2002; included in Annex A of this volume).

To increase understanding and facilitate policy making, this functional definition of PCD needs to be "unpacked". Thus, Fukusaku and Hirata (1995) define policy coherence for development as "the consistency of policy objectives and instruments applied by OECD countries individually or collectively in the light of their combined effects on developing countries." In turn, this formulation combines four dimensions:

1. ***Internal coherence***: the consistency between goals and objectives, modalities and protocols of a policy or programme carried out by an OECD member government in support of development (*e.g.* aid).
2. ***Intra-country coherence***: the consistency among aid and non-aid policies of an OECD member government in terms of its contribution to development (joined-up policies).
3. ***Inter-donor coherence***: the consistency of aid and non-aid policies across OECD member countries in terms of their contribution to development.

4. ***Donor-recipient coherence***: the consistency of policies adopted by rich and poor countries to achieve shared development objectives.

While they may be governed through distinct decision-making structures, these four types of coherence are closely interrelated. In the real world of policy implementation, decisions that affect coherence along one dimension have implications for coherence in one or more of the other three dimensions. The traditional focus of PCD has been on Type 1 coherence – the alignment of means with goals in development assistance. But attention to the other three dimensions is growing.

The increasing emphasis on results associated with new public management has led to a preoccupation with improved co-ordination across government departments – Type 2 coherence ("joined-up government" approach). In parallel, the rising number of actors in the development system has brought to light the need to reduce aid transaction costs through improved co-ordination and harmonisation – a Type 3 coherence issue. As the limits of aid conditionality and the role of ownership in development effectiveness have emerged from the lessons of experience, Type 4 coherence has come to the fore.

The OECD Development Assistance Committee (DAC) considers that policy coherence for development includes but goes beyond policy co-ordination and policy consistency and "involves the systematic promotion of mutually reinforcing policy actions across government departments and agencies creating synergies towards achieving the defined objective" (OECD, 2001). The four dimensions of coherence captured by the typology apply equally well to this broader, more constructive view of achieving coherence.

Central PCD issues

The increased interdependence of societies and nations has vastly increased the benefits of policy convergence among development partners. Fuelled by demography and the new information and communications technologies, economies and societies have become inextricably interconnected, as argued in Chapter 1 of this book. OECD countries rely on developing countries for a third of their export sales and one half of their oil consumption. Developing countries depend on OECD member countries for over 60% of their trade and about half of their commodity imports. Mutual benefits flow from aid, trade, investment and migration. With globalisation, new economic opportunities (in trade, investment and knowledge transfer) have emerged – but so have a host of "problems without passports".

The recurrent financial crises, the terrorist attacks of 9/11 and 3/11 and the SARS and avian flu epidemics illustrate the risks to peace and prosperity associated with lack of international co-operation in an interdependent world. Unless major progress towards policy coherence for development is achieved, most developing countries will not achieve the Millennium Development Goals (MDGs) solemnly endorsed by all United Nations (UN) members at the turn of the century.

The baseline for all the MDGs is 1990. Most MDGs have been set for achievement by 2015. Halfway to the deadline, the implementation record is mixed. Reduced incidence of malnutrition among children, improved maternal health conditions and increased primary school enrolment (especially for girls) represent notable achievements. But the current rate of progress is too slow to achieve most of the goals. Only a third of developing countries are on track to meet them. Regional differences are striking. The zones most in need of development (most of Africa and large parts of South Asia) are lagging. At current growth rates, East Asia alone is likely to achieve the agreed income and poverty-reduction objectives (Vandemoortele, 2003).

Working to achieve Type 1 coherence (coherence between the ends and means of aid) has been a traditional focus of the OECD's Development Assistance Committee (DAC) activities since its inception. This has involved extensive work on aid effectiveness at the project and programme levels. It has also involved advocacy work to encourage member countries to raise the volume of aid. Both objectives remain highly relevant. First, aid quality needs to be improved. Administrative costs absorb 6-7% of aid flows. Tied aid costs about USD 5-7 billion a year in needless mark-ups for goods and services. Much of the technical assistance funded by aid has low value. The poorest countries get less than 30% of the aid and the share of aid allocated to basic social services is about half of the levels recommended by the UN (20/20 principle)[6].

Second, current aid levels are not sufficient to achieve agreed goals. The goal of 0.7% of gross national income (GNI) for aid enshrined in numerous UN conferences has only been reached by a handful of countries. Even if the commitments announced at the UN Financing for Development Conference in Monterrey are met and aid grows by 31% in real terms by 2006 (about USD 16 billion), aid volumes will remain inadequate. The 2001 report (UN, 2001) of the High-level Panel on Financing for Development (Zedillo Report), estimates that an extra USD 50 billion in development aid per year would be required to meet the MDGs, that an additional USD 8-9 billion would be required for basic humanitarian assistance, and a further USD 20 billion to address "global public goods" issues (*e.g.* the environment) in a more satisfactory manner. The 2005 UN Millennium

Project estimates the costs of meeting the MDGs in all countries to be around USD 121 billion in 2006, rising to USD 189 billion in 2015 (UNDP, 2005).

But the Type 1 and Type 2 coherence goals that are at the heart of the PCD initiative go well beyond aid and require a "whole of government approach". Ultimately, they aim at establishing a level playing field for the global economic order.[7] Box 0.1 provides illustrations of Type 2 incoherence issues that may require policy adjustment in OECD member countries (in combination with compensation schemes for losers) in order to achieve win-win outcomes.

Box 0.1. **Some examples of potential policy incoherence**

- Agricultural policies in OECD member countries aim to sustain a cherished way of life (the 'agrarian myth') but they in fact benefit very few citizens – mostly prosperous farmers and agro-industrial firms. They protect domestic supplies of crop and livestock products that can be produced at a fraction of the cost in developing countries. Tariffs and subsidies impose heavy costs on consumers and taxpayers in OECD countries. They undermine equitable growth in the developing world, where the majority of the poor live.
- The highest tariffs on industrial goods imposed by OECD member countries affect products that are critical to the economic well-being of developing countries – steel, textiles, clothing and leather -- and raise prices for consumers in OECD countries.
- The protection of intellectual property under World Trade Organization (WTO) rules promotes research and innovation but it also restricts access to essential drugs and other knowledge intensive products and services in poor countries.
- Immigration restrictions are imposed to sustain domestic wages, as well as for other reasons, but these policies may restrict increased remittances to developing countries and aggravate labour shortages in OECD member countries faced by an unprecedented demographic transition. For certain professional skills that are scarce in OECD countries, policies that seek to attract skilled labour from developing countries, *e.g.* in the health and science fields, create uncompensated skill shortages in the source countries to the detriment of their development.
- Fishing subsidies of OECD countries absorb USD 15-20 billion a year, benefit large companies more than poor fishing communities, and deplete fish populations on which poor countries' coastal fisheries depend.
- Industrialised countries (home to 20% of the world's population) account for 63% of carbon dioxide that has accumulated in the atmosphere since 1900. Global warming will impose heavy costs on developing countries. Small island economies are especially vulnerable.
- A recent law that mandates counter-terrorism protection measures in ships and ports imposes heavy investment costs on poor countries that lack budgetary resources for social programmes.

Ongoing work at the OECD and elsewhere addresses coherence issues like these, notably concerning coherence between development assistance policies and those of the trade, agricultural, fisheries, migration, health and environmental policy communities. The work includes analytical frameworks to help decision makers understand policy interactions and their impacts on agreed development objectives.

In this volume, the first in the new series on "the development dimension" of OECD member country policies, the opening chapter provides an overview of issues of policy coherence for development, focussing on the well-known trade-agriculture nexus and on areas not covered in later chapters – governance, migration, and sustainable development. It sets PCD in the context of the evolving global economy, arguing that the first decade of the 21st century is a crucial moment when OECD country relations with emerging economies (including the world's most populous countries) will be challenged.

The next two chapters address two areas – macroeconomic policy (Chapter 2) and the international financial architecture (Chapter 3) – where PCD has been neglected in the past but in which it is moving to centre stage, with the globalisation of capital movements. Policy coherence today cannot ignore macroeconomic interdependence or the mutual repercussions of policy actions. And in the context of insufficient and unstable capital flows to developing countries, the development of new mechanisms, as well as developing country representation in key international fora, raise PCD issues. Chapter 4 investigates the determinants of the degree to which PCD is currently achieved. It examines the politics and policies of development assistance and the PCD agenda for a range of DAC members. Finally, Chapter 5 analyses issues and options regarding how to evaluate OECD countries' success in achieving greater PCD, a domain thus far unexplored.

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NOTES

1. Robert Picciotto is Visiting Professor, King's College, London and former Director-General, Operations Evaluation, the World Bank.
2. See *Webster's Dictionary of the American Language*, College Edition, World Publishing Co, New York, 1962*; The New Shorter Oxford English Dictionary*, Clarendon Press, Oxford, 1993.
3. This explains why policy research and evaluation are public goods that tend to be under-financed.
4. Recent controversies about the intelligence available prior to 9/11 (crying wolf too late?) and the Iraq war (crying wolf too early?) illustrate this principle.
5. For an in-depth treatment of improved governance for PCD, see OECD (2005), *The Development Dimension: Promoting Institutional Good Practice*, OECD, Paris.
6. The 20/20 principle: whereby at least 20% of ODA and 20% of government expenditures would be spent on basic social services, such as access to clean water and sanitation, primary education, family planning services and others.
7. Debt reduction policies remain too restrictive: official development assistance to least developed countries has shrunk from 12% to 7.5% of their GDP while debt service is about 3% of GDP.

CHAPTER 1

THE SHIFTING BALANCE IN THE GLOBAL ECONOMY

By Richard Pomfret[1]

The combination of increasing global integration and internationally agreed development goals puts pressure on OECD countries to share the economic advantages of the market economy. They need to ensure that the global system is flexible enough to adapt to changes in economic power and that the dispossessed are not left behind. This calls for coherence across OECD member policies as part of a global bargain and in their own best interests. Chapter 1 assesses the drivers of the economic prosperity of the second half of the 20th century and previews the rapid growth catch-up phase ahead for many non-OECD economies. It highlights the transborder economic and political issues that accompany globalisation and mobility, in particular the threats to the liberalised trading system posed by bilateral negotiations and refusal to accept shifts in comparative advantage from rich to poor countries. It raises issues related to labour mobility and their implications for development, as well as those of intellectual property, the global commons and global public goods. The analysis recommends systematic assessment of the development implications of all policies as an integral part of OECD member country decision-making.

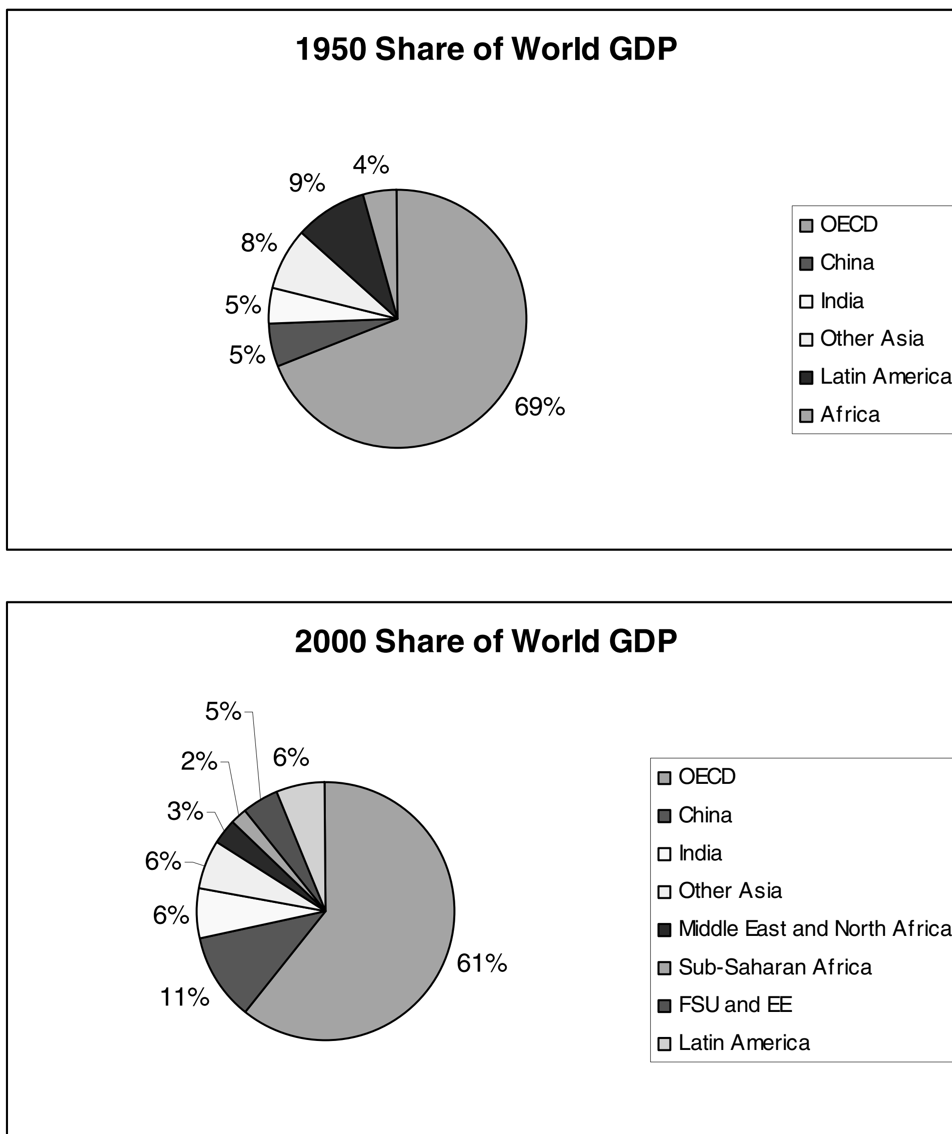
The Millennium Declaration, approved by the largest ever gathering of heads of state in New York in 2000, ushered in a new era of global co-operation for development. Two years later, at the United Nations (UN) Conference on Financing for Development in Monterrey, specific goals were agreed. The first seven Millennium Development Goals (MDGs) were explicitly targeted at developing countries, but the eighth MDG set out the role of the rich countries in this development compact. Although less precise than the first seven MDGs, the eighth goal commits OECD member countries to policy coherence in development.

It is no longer acceptable to set targets and then not align priorities across all relevant policy areas. OECD governments work to reduce incoherence across policies, but the pressure to do so has been much less with respect to promoting development than with respect to domestic or traditional foreign policy goals. During the last half of the 20th century, development assistance meant aid, and even this saw a declining priority in most OECD countries' public expenditures. Although it was recognised that the value of aid was offset by trade or agricultural policies which worked against developing countries, little attention was paid to such incoherence and little systematic analysis was made of the broader range of incoherence in policies for development. The MDGs challenge this neglect, because now there is a formal commitment to policy coherence for development (PCD) as part of a global bargain.

The second half of the 20th century was the most economically successful half century in human history. The success was in no small part due to the liberal international economic order embodied in international trade law and other elements of global financial architecture. This system was created by OECD member countries, who were its main beneficiaries. It was not a perfect system and the playing field was uneven, but it did provide opportunities for development which were seized by a handful of fairly small developing economies. Although the OECD countries' global economic dominance declined, the change was small and by the end of the century they still dominated the world economy (see Figure 1.1) and the institutions governing it. Most non-OECD countries failed to take full advantage of their economic potential, but this situation has been changing in recent years as more countries achieve high growth rates – notably the world's two most populous countries, China and India – and they seek greater input in designing or modifying the playing field.

The distribution of world gross domestic product (GDP) will continue to evolve, and the next half century will see a rapidly falling share for OECD member countries. This is not because OECD member country citizens will become poorer – far from it – but rather because much of the rest of the world will be in a rapid growth catch-up phase. This will have many implications, including increased

Figure 1.1. **Changing shares of world GDP, 1950 and 2000**



Note: GDP measured at purchasing power parity (PPP).

Source: 1950 from Maddison, Angus (2001), *The World Economy: A Millennial Perspective*, p. 261; 2000 from Penn World Tables.

demands for non-OECD countries to have a bigger say in global institutions. It will also put greater pressure on OECD member countries to honour their commitment to design coherent policies that promote development without arousing resentment.

Global economic integration will increase the pressure for PCD in other ways. Greater international interdependence and improved information technology (IT) will increase transparency and make it harder to hide policy incoherence. The poor countries, many of which are doing a better job of meeting their side of the MDG compact, will be able to point to failings among rich countries in meeting their PCD obligations. Within the OECD member countries, the widespread response to the tsunami disaster of December 2004 indicated that many people recognise that they live in a global community. This sense of common community can be built upon to push aid commitments back up towards the goal of 0.7% of GNI and to ensure that the development priority informs policy design in all areas.

Evolving shares of world GDP – the shifting balance

The major source of increasing global inequality since the early 1800s has been increasing inequality across nations; inequality within countries has been much more stable (Bourguignon and Morrison, 2002; Williamson, 2002). There have been changes in global leadership, with the rise of the United States and later Japan, and struggles for hegemony within Europe as Germany caught up with the United Kingdom and France, but the division between rich and poor countries was clear-cut by the mid-20th century. A small number of countries produced a large proportion of global output and hence dominated the global economy: this situation did not change substantially in the remainder of the 20th century.[2]

In the 21st century, evolving shares of world GDP are placing new strains on global institutions. The rapidly growing economies of the third quarter of the 20th century posed less of a challenge, because Japan and Korea could be accepted into the OECD and assume the status of developed countries in other fora, while the other newly industrialising economies were fairly small.[3] Recent high-growth countries, however, include the world's two most populous countries – China for a quarter century and India more recently. Other populous nations are also becoming more active in international institutions as Brazil sheds its inward-looking policies, as the Indonesian economy has enjoyed three decades of rapid growth, and as Russia re-establishes a market economy. These "Big Five" countries contain 46% of the world's population and account for 8% of global GDP (Tables 1.1 and 1.2).

The large fast-growing non-OECD countries expect to have a greater say in the design of the global economic architecture and seats at the drafting tables. Traditions

of consensus, such as in the World Trade Organization (WTO), are harder to maintain, while weighted voting or selective veto power, as in the Bretton Woods institutions or the UN Security Council, is based on conditions that appear anachronistic to the economically ascending nations. For the OECD member countries, the challenge is how to accommodate these aspirations without threatening the features of the global economic system that have underlain the historically unprecedented increases in global living standards since 1945. The most fundamental challenge is to gain the economic advantages of the market economy, which has driven increases in efficiency and living standards unmatched by rival economic systems, while at the same time ensuring that the global economic system is flexible enough to adapt to changes in economic power and not leave the dispossessed behind.

Table 1.1. **Countries with population over 100 million, 2003**
In millions

China	1 288
India	1 064
United States	291
Indonesia	214
Brazil	177
Pakistan	148
Russia	143
Bangladesh	138
Nigeria	136
Japan	127
Mexico	102
World	**6 301**

Source: World Bank, World Development Indicators.

Table 1.2. **20 largest economies, 2002**
GDP, in USD billions at market prices

1	United States	10 417
2	Japan	3 979
3	Germany	1 976
4	United Kingdom	1 552
5	France	1 410
6	China	1 237
7	Italy	1 181
8	Canada	716
9	Spain	650
10	Mexico	637
11	India	515
12	Korea	477
13	Brazil	452
14	Netherlands	414
15	Australia	411
16	Russia	347
17	Switzerland	268
18	Belgium	248
19	Sweden	230
20	Austria	203

Notes:

World GDP = 32 252 / OECD GDP = 26 269 (according to *OECD in Figures*)

Other populous countries: Indonesia 173 (26th), Pakistan 61 (47th), Bangladesh 47 (51st), Nigeria 44 (53rd)

Source: World Bank, World Development Indicators.

Shares of world GDP are also changing for less positive reasons. Latin America, Africa and parts of Asia have all experienced disappointing growth episodes in recent decades. Increases in poverty by the headline dollar-a-day measure have been concentrated in Sub Saharan Africa and the ex-USSR, although the number of poor people in South and East Asia remains high (see Table 1.3). About half of the world's population lives on less than two dollars per day. This provides a challenge to the well-off to ensure more equitable distribution of global incomes, particularly in regions where poverty has been combined with conflict and epidemics.

How will the distribution of the world's GDP change in the 21st century? The current consensus in growth theory is that once institutional conditions are reasonably favourable, countries will pursue pro-growth policies and experience

rapid catch-up to the technological leaders (see Box 1.1). Historically this has never involved more than a handful of countries at a time, but by the beginning of the current century, most of the world's countries appear to have experienced the decisive changes needed to ignite sustained growth.[4] A simple catch-up model of the global economy would have OECD economies continuing to grow, but the rest of the world growing much faster. With plausible parameters, the OECD countries' GDP could increase 2.5 times by 2050 and non-OECD countries could experience an eightfold increase in GDP – implying a decline in the OECD countries' share of global GDP by over half between now and 2050.[5] Such projections obviously rely on the underlying model's applicability and on the absence of unexpected shocks (and may be too optimistic for some countries), but the predicted non-OECD growth rate is not unlike that achieved by the newly industrialising economies of the second half of the 20th century.

Table 1.3. **Poverty in developing countries**
Million people living on less than I$1 per day at PPP

	1990	2001
East Asia and Pacific	472 (29.6)	284 (15.6)
Europe and Central Asia	2 (0.5)	18 (3.7)
South Asia	462 (40.1)	428 (31.1)
Middle East and North Africa	6 (1.6)	7 (2.4)
Sub Saharan Africa	227 (44.6)	314 (46.5)
Latin America and Caribbean	49 (11.3)	50 (9.5)
World	**1 219 (27.9)**	**1 101 (21.3)**

Notes: The units are international dollars (I$), based on the purchasing power of a 1993 US dollar. Numbers in parentheses indicate percentage of the region's total population living in poverty.

Source: World Bank data at www.developmentgoals.org/Poverty.htm#percapita, accessed 24 January 2005.

Box 1.1. **Catch-up growth**

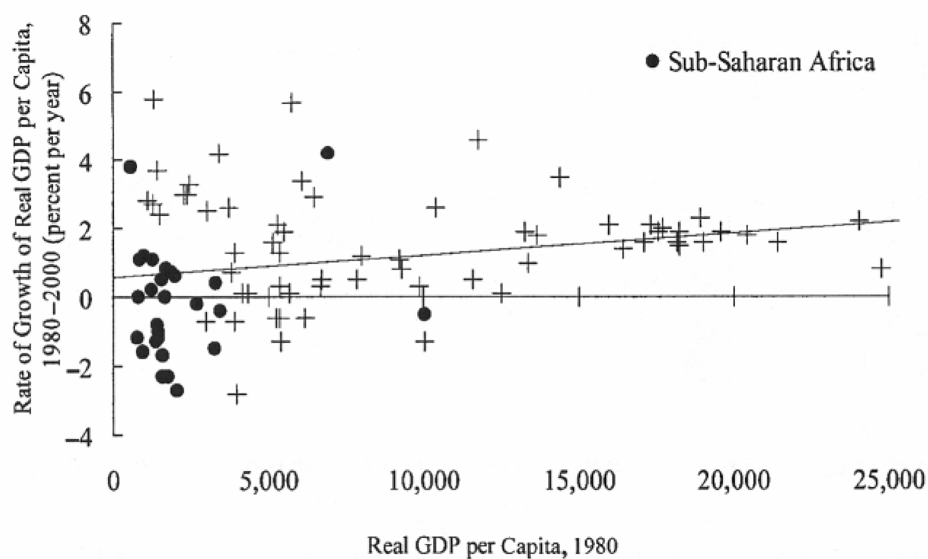
The idea that "follower" countries can learn from the experience of the economic leaders, or take shortcuts to speed their development process, is an old one. Alexander Gerschenkron, drawing mainly on the experience of Germany and Russia, popularised the benefits of "backwardness" in the sense that latecomers are able to grow faster once their growth begins. Neoclassical growth theory in its simplest form implies convergence, as low-income capital-poor countries adopting freely available best-practice technology have a higher marginal productivity of capital and hence higher growth rate than capital-abundant developed economies. Over the long run, however, the cross-country evidence has exhibited what Lant Pritchett has dubbed "Divergence Big Time", as the gap between rich and poor countries' incomes widened substantially between the early 1800s and the late 1900s.

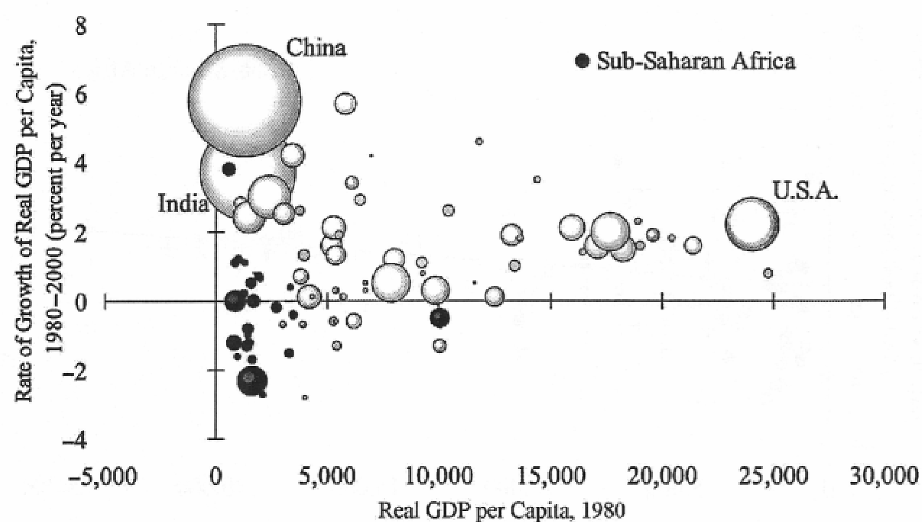
In modern growth theory theoretical convergence and empirical divergence are reconciled by the concept of conditional convergence. With appropriate institutions and polices, low-income countries converge towards high-income countries' income levels, but without appropriate institutions and policies, their economies stagnate. In cross-country growth regressions pioneered by Robert Barro and others, conditional convergence is captured by a negative coefficient on initial income levels when conditioning variables, such as measures of human capital, of sound monetary and fiscal policy, and of openness, are included on the right-hand side of the regression equation. Although debates continue over the deeper determinants of convergence, *i.e.* why some countries adopt good policies while others do not, there is a growing consensus about the nature of good policies.

When a few economies have appropriate conditions for catch-up growth to take place, while the majority continue to stagnate, conditional convergence is accompanied by absolute divergence. This was the state of the world economy from 1800 to 1950. Absolute convergence only begins when enough countries have appropriate conditions for catch-up growth. During the 1960s and 1970s the newly industrialising economies showed how fast catch-up growth could be in the contemporary environment, but because their number and individual sizes were small, their growth had little impact on the global income distribution. In the 1980s and 1990s the situation changed as China, and subsequently India, appear to have set off on catch-up growth trajectories, signalling a decrease in global inequality.

Stanley Fischer has neatly illustrated the evidence from the past two decades. In the top panel of Figure 1.2, each data point is a country. Countries with higher initial incomes grew faster; this is reflected in the upward-sloping regression line, but the large number of low-income low-growth countries in Sub Saharan Africa influence this result. Weighting observations by population (bottom panel of Figure 1.2) highlights the convergence of individual incomes as China and India, and several other large and medium-sized countries, experienced high growth over the last two decades.

Figure 1.2. **Average annual growth (1980-2000) and initial level of real GDP**





Note: The areas of circles in the bottom panel are proportional to 1980 population.

Source: Fischer, S. (2003), "Globalisation and its Challenges", *American Economic Review 93(2)*, May, 1-30, data from Penn World Tables 6.1.

In sum, the challenge to the dominant position of OECD member countries will become more pronounced in the coming decades. During the 1990s, headlines were riddled with critics of globalisation demonstrating in Seattle and Genoa, but the MDGs affirm that all countries agree, and have an obligation, to make globalisation work for the common good. This reflects consensus among governments that globalisation has been of far more benefit than harm – not least to countries in the catch-up phase – and it is unlikely that the ascending countries will challenge the notion of globalisation.

What is more likely is that they will question the global economic framework which has been established by the rich countries. The desire to work within the system is evident from China's accession to the WTO in December 2001 and Russia's imminent WTO accession, and from the much more active roles played by Brazil and India in the Doha Development Round than at any time since the 1950s (when India led the opposition to a liberal non-discriminatory world trade regime). This shifting balance will involve greater competition and need for change in all participants in the global economy. The challenge for the OECD countries is to respond to legitimate demands, while maintaining the strengths of the current system, and to ensure coherence of their own policies.

How globalisation increases policy interdependence

After a century of global integration, which was associated with increasing global output and increasing inequality across nations, the global economy went through three dismal decades between 1914 and 1945. This trend was reversed after 1945 by an integration process that was largely policy-driven. Trade liberalisation led the way, assisted by technical change that reduced transport costs, and by liberalisation of capital and labour flows.[6]

Since 1945, global incomes have risen at an unprecedented speed, and several countries classified as less-developed in the 1950s now have living standards comparable to the rich countries. Although the policy mix varied, a common feature of the "less-developed" countries was that, once appropriate institutions and polices were in place, rapid catch-up growth followed. The performance of the high-growth countries was aided by robust and fairly steady growth within the OECD countries and a substantial opening of these countries' markets. Although debates about the precise relationship between openness and growth remain unresolved, all of the economic success stories of the last half century have benefited from access to global markets, while the least outward-oriented economies are far behind.

In the 1950s and 1960s most of the world enjoyed unprecedented economic growth, accompanied by substantial liberalisation of the OECD member countries' trade policies. Economic growth was an almost universal phenomenon, although it was especially noteworthy in the recovery "miracles" of Germany, Italy and Japan, and in a group dubbed the "newly industrialising economies" in a 1975 OECD report. The decade 1973-82 was less positive, although oil exporters enjoyed rapid growth and many low- and middle-income countries maintained economic buoyancy on the back of external debt as banks recycled petrodollars. That buoyancy ended when the Debt Crisis hit many countries in Latin America, Eastern Europe and Sub Saharan Africa in 1982. This was followed by an era of much greater economic volatility – the "lost decade" in Latin America and a gloomy two decades for much of Sub Saharan Africa; rapid growth in China and elsewhere in East Asia; the collapse of central planning in Eastern Europe and of the Soviet Union; and a seemingly continuous (and increasingly frequent) series of financial crises in individual countries or regions.

One silver lining to the 1982 Debt Crisis and its aftermath was the almost complete discrediting of the import-substituting industrialisation strategies that had been pursued by many of the heavily indebted countries, in contrast to the high-performing East Asian countries whose outward-oriented economies continued to boom through the 1970s and 1980s. The ascendancy of market-friendly economic development strategies was reinforced by the success of economic reform in China and Vietnam and the collapse of central planning in Eastern Europe and the former Soviet Union. By the 1990s, the commitment to market mechanisms in the global economy was the most universal it had been for almost a century. A connected phenomenon has been the liberalisation of political systems; between 1985 and 2000 the number of authoritarian regimes fell from 67 to 26, while the number of countries characterised by the United Nations Development Programme (UNDP) as "most democratic" rose from 44 to 82 (UNDP, 2002).

The late 20th century saw the continuing rise of globalisation – and increasing challenges. Global economic growth in the 1990s was strong, led by the buoyant US economy and robust growth in other OECD countries, such as Australia and Canada and parts of the European Union; but also characterised by lacklustre growth in Japan and crises in Mexico and Turkey. The non-OECD countries experienced great variation in growth, both over time and across countries. Crises in East Asia, Russia, Argentina and elsewhere hit the headlines, although there was often a failure to distinguish between countries that recovered in better economic shape from the crisis (such as Mexico or Russia or Thailand) and countries that went into an economic tailspin (such as Argentina or Indonesia).[7] More seriously it was becoming ever clearer as incomes rose in many middle-income countries that some countries were being passed by and the gaps were widening. The countries with

declining incomes were mainly in Africa, but also included countries from the Caribbean, from Asia (*e.g.* Myanmar or Tajikistan) or even Europe (*e.g.* Moldova).

What have been the main elements of globalisation? Trade liberalisation in the form of reducing tariffs and quantitative barriers to trade was largely completed by the rich countries by the time the WTO replaced the General Agreement on Tariffs and Trade (GATT) in 1995. Barriers to merchandise trade still exist (see below), but they are mainly in the form of non-trade policies with trade consequences (such as farm subsidies) or contingent protection that is gradually being brought under the WTO umbrella. Some non-OECD countries continue to levy high tariffs or impose other trade barriers, and a handful of trading nations remains outside the WTO. Nevertheless, with the WTO accession of China at the end of 2001 and the anticipated WTO accession of Russia, global goods trade liberalisation and acceptance of a common trade law are close to becoming a reality.

Liberalisation of trade in services, where the potential welfare gains are higher than from further liberalisation of goods trade, has moved more slowly. In key areas relevant to globalisation, however, there have been substantial cumulative changes. In air transport and other international transport, the highly restrictive regimes of the mid-20th century have been substantially liberalised. Many national monopolies on telephone services have ended, and where they remain they are undermined by the technology of mobile phones. In other areas of communications, such as the Internet, the issue has been how to regulate an inherently liberalised medium. Financial and business services, though still heavily regulated in national markets, are far freer in international markets; again debates are about how to regulate (in this case the movement of money for illicit purposes) given the liberal global capital markets. Another example of market-driven liberalisation is the provision of education services, as more students travel overseas, particularly to complete secondary school or for post-secondary education. The financial value of these flows is hard to calculate, but, as with other movements of people, they play a major role in disseminating ideas, not least about the economy.

Capital market liberalisation has also proceeded more slowly than goods trade liberalisation. International financial markets took time to recover from the debacles of the 1920s and 1930s. Even among OECD member countries, capital mobility was only gradually restored in the 1950s and 1960s, and the last capital controls within the European Union were not removed until the early 1990s. Few non-OECD countries had access to international financial markets until the 1970s and the double-edged experience of sovereign borrowers during that decade warranted caution by both borrowers and lenders through the following decade. Although many non-OECD countries still impose restrictions on capital flows and on currency convertibility, their number is declining. The challenge is to provide emerging

economies with policy space while they adapt to long-term pressures for integration into global financial markets.

Foreign direct investment (FDI) flows have been largely independent of capital markets. After being restricted by many non-OECD countries in the 1960s and 1970s due to fears about exploitation or about erosion of sovereignty, FDI was much more keenly encouraged after bank loans dried up after 1982. Growth in FDI has been volatile, but with a strong long-term upward trend. The establishment of global production networks and worldwide brands, often involving some FDI, have been salient features of the global village. For anti-global-activists McDonalds or Nestlé or Toyota became emblematic of what they were fighting against, even as the world's consumers welcomed the price-quality competitiveness of the most successful global brands. For many fast-growing economies, transnational corporations and FDI have been important conduits for technology, management and marketing expertise, and ideas, as well as suppliers of capital.

By the start of the 21st century, financial markets became truly international, although liberalisation of international capital movements without appropriate institutional development in national financial sectors has brought problems. While low-cost capital mobility is desirable to finance trade as well as to transfer funds from net saver countries to their most productive location, it also exposes economies to financial crises if holders of liquid assets abandon a country or its currency. Moreover, side effects such as the increased ease with which cash from illegal activities can be transferred from the country of origin to a safe haven, or with which cash can be mobilised to support international crime or terrorism, raise difficult questions of trade-offs between efficiency and security, and between the rights of regulators and the rights of depositors in financial institutions.

Solutions to these problems require new levels of international co-ordination, both in agreeing on the appropriate intervention and in implementation. Chapter 3 discusses institutional reforms to promote stable financial flows to developing economies, and analyses an example of legislation being negotiated among the rich countries which could have unintended negative consequences for capital flows to poor countries. While the G7 have accepted the desirability of macroeconomic policy co-ordination for at least 20 years, the implications of OECD member country macro-policy decisions for non-OECD economies have generally been ignored. But, as Chapter 2 shows, US and EU macro-policy is transmitted to China, and by extension to other large emerging countries which become integrated into the global trade and financial system, via interest and exchange rates: there could be important feedback mechanisms to OECD countries if, say, China responds by shifting its reserve holdings from dollars to euros.

People are moving around the world in unprecedented numbers, but "permanent" migration and the acquisition of citizenship remain contentious political issues. In the global economy, subcontracting of services and short-term business trips are becoming increasingly visible aspects of cost-effective production chains and knowledge transfer. The obstacles to such short-term mobility have been falling, often as part of regional agreements (as in the European Union, or to a lesser degree among the South African Development Community [SADC] or Asia-Pacific Economic Cooperation [APEC] members, or in the Puebla Process in North and Central America). But this challenges the ability of nations to effectively regulate their restrictions on long-term immigration.[8] Increasingly, restrictions are being placed on unskilled immigrants, which encourages a "brain drain" from poorer countries, while removing a safety valve from countries in turmoil (as refugees have greater difficulty in finding a welcome mat) or with population pressure.[9] As the OECD Secretary-General, Donald Johnston, has said:

> Obviously, preventing migration would be unacceptable, the movement of labour being a fundamental freedom we uphold. But there is still incoherence in terms of a development strategy when OECD governments actively solicit skills from the developing world that cannot easily be replaced. Some coherence might be restored, for instance, if public policy in destination countries required some compensating payment in return. (Johnston, 2004)

Mobility has also raised the spectre of cross-border terrorism, highlighted by the events of September 11th in the United States and the Bali bombing in 2002. Concerns about safety from foreign terrorists even in the heart of the largest US city, or similar concerns about safety in one of the most popular Asian destinations for foreign tourists, cast a pall over travel and freedom of entry. As OECD member countries review and tighten their policies towards visas and other entry procedures, it is important to weigh the benefits against the costs imposed on legitimate travel, and to avoid unnecessary discrimination against travellers from less familiar regions.

Although markets for goods and services, for capital and for labour remain far from globally integrated, substantial progress has been made on the first three of these. This has served to bring other elements of the global economy into the spotlight. The major obstacle to increasing the efficiency of the global economy in the 21st century is the difficulty in enforcing property rights across national borders. This appears to account for the still substantial "border effect" in trade between even close neighbours with similar institutions such as Canada and the United States. More generally, economists have become increasingly aware that the remaining obstacles to international trade are primarily "behind the border" rather than traditional trade barriers (Anderson and van Wincoop, 2004). This is reflected in

moves to bring competition policy and other areas of policy harmonisation into global trade negotiations; such steps should consider not just the interests and capabilities of the major trading nations in the OECD, but also the interests of poorer trading nations, which may have less capacity to benefit from complex international codes.

In the broadest terms, globalisation makes it important for economic agents to believe they have some protection of their rights in all countries. The current battleground of intellectual property rights (IPRs) inevitably pits rich countries, who have most of the economically valuable intellectual property, against poor countries hoping to benefit from technology transfer in order to facilitate catching up to the rich. Without protection of IPRs there is likely to be suboptimum investment in identifying and developing new ideas, processes and products. On the other hand, stringent patent laws can inhibit further development of new technologies that would be beneficial to all. Moreover, in some areas, notably medicine, there may be pressing humanitarian reasons why poor people in low-income countries should have access to products whose price reflects patented IPRs. The challenge is to balance the need to reward innovators with the benefits of low-cost availability of new products.

Developing countries are often at a disadvantage in protecting their legal rights in other countries. An example is anti-dumping legislation. The threat of an anti-dumping investigation often encourages poor countries to negotiate a disadvantageous "voluntary" restraint on their exports, whereas rich country exporters will hire lawyers to defend their interests. Particularly egregious have been the delays in making final determinations in anti-dumping cases against imports from Soviet successor states, some of which are still considered as non-market economies and hence liable to punitive constructed-price calculations of anti-dumping duties (long after completion of the transition from central planning). Such approaches to unfair trade practices may be non-discriminatory in intent, but in practice have discriminated against countries less capable of defending their rights in other countries' courts. This provides a lesson for the design of new codes on domestic policies which inhibit trade. In dealing with anti-competitive practices or unnecessary domestic regulations which restrict trade, it is important not only to reach international agreement on what is, and what is not, acceptable practice, but also to ensure that channels for enforcing rights under such agreements are not beyond the reach of developing countries.

Making the liberal trade regime work for development

Central to the post-1945 economic order has been the international trading system,[10] whose cornerstone, enshrined in GATT Article I, is the non-discrimination principle. Any WTO member must pass on any benefit granted to the most-favoured trading partner to all other WTO members. OECD member countries have generally passed on unconditional most-favoured nation (MFN) treatment to non-WTO members as well. Combined with the substantial reduction in trade barriers negotiated in successive rounds of multilateral trade negotiations, this has been crucial to the global prosperity of the last 50 years. Despite the lip service paid to these principles by all OECD member countries, they are being undermined by threats to the unconditional MFN principle and reluctance to apply WTO principles to all sectors.

During the 1970s and 1980s, "trade not aid" rhetoric was used to legitimise preferential trading arrangements. The Generalized System of Trade Preferences for developing countries, launched with much hype in the early 1970s, was so designed by the importing countries that it yielded little benefit to developing countries – an experience that partly explains the focus on the WTO by developing countries today. Special tariff treatment is now mostly reserved for very poor countries whose exports pose little threat to domestic interests in the importing countries. The preference margins are being eroded by MFN tariff cuts.[11]

Today the MFN principle is threatened by a proliferation of bilateral agreements involving OECD member countries and non-OECD members which deal mainly with non-tariff matters such as access to financial markets and other behind-the-border measures. These bilaterals are tailored to enhance trade between the signatories, but are typically discriminatory against third parties.[12] The large trading nations are powerful enough to ensure that they do not suffer from other countries' bilateral agreements, but developing countries are less able to forestall arrangements which lead to their losing market share to preferred suppliers. The use of preferential or bilateral arrangements by major trading nations threatens to politicise international trade, by encouraging political leaders to use granting (or not granting) special treatment as a reward (or punishment) for smaller countries following (or failing to follow) a desired non-trade policy. Such short-sighted nationalism interrupted progress towards global integration during the early 20th century and was a contributing cause of two world wars.

New anti-terrorism measures also threaten the MFN principle. Stricter port and container security is less stringently imposed on imports from countries with bilateral trade agreements which can ensure physical security throughout the supply chain. If implemented as planned, such measures will increase the costs of

international trade and will benefit more developed countries relative to less developed countries – for example, Singapore relative to Indonesia.

Within multilateral trade negotiations, where OECD member countries' official trade stance is in favour of liberalisation, other policies reduce the probability of a positive negotiating outcome. In the Uruguay Round, OECD member countries secured consensus by agreeing for the first time to include agriculture and to bring goods covered by the Multifibre Arrangement (MFA) under normal trade law. Implementation on these two items was, however, slow and, as the time for implementation approached, failed to live up to expectations of non-OECD countries. The round launched in Doha in 2001 is described as the Development Round, but the September 2003 Cancùn Ministerial broke up in acrimony, largely because of failure by the major trading nations to show much negotiating flexibility in the areas of agriculture and textiles.

Agriculture has become a *cause célèbre* of OECD countries cosseting a small but politically influential group at the cost of stated commitments to trade liberalisation. For the European Union, the common agricultural policy has been an internal matter, effectively non-negotiable with non-members. While the United States has vigorously sought to change the EU's agricultural policy, its own farm support programmes remain extensive. Given the slow pace of agricultural reform in the European Union and United States, other OECD member countries free-ride in protecting farmers: a Canadian cow earns more in government aid than the per capita income of many African countries; Australian rice and cotton farmers pay bargain-basement water prices in the world's driest continent; and Japanese and Korean rice farmers are a cultural treasure.

The agricultural situation is improving only slowly and even that progress is under threat. The best single measure of assistance to OECD member country farmers is the value of producer support estimates (PSEs) as a percentage of farm receipts, and this fell from 38% in 1986-88 to 31% in 2000-02. The variation among OECD member countries is large. PSEs, as a percentage of farm receipts, are highest for Iceland, Japan, Korea, Norway and Switzerland (all over 60% on average). The averages for the European Union (36%) and the United States (18%) are lower, but because of the size of their farm sectors, EU and US agricultural policies significantly impact on international markets. These policies hurt potentially competitive farmers in rich and poor countries alike, but the poor countries surely suffer most, especially where there is little non-farm employment. The fact that rice and sugar are the most heavily supported commodities particularly impinges on the many poor countries that are competitive in producing these crops. Formal trade barriers and subsidies are only part of the trade-inhibiting distortions, which also include sanitary, quarantine, technical and other regulations whose impact is hard to

measure. While some of these restrictions are justified on public-health grounds, the overall effect of the restrictive agricultural policies is to penalise consumers in OECD member countries.

In 2003, OECD members agreed on a "Positive Reform Agenda", which included increased responsiveness to price signals and integration of agriculture into the world trading system. The extent to which the agenda will be implemented remains uncertain. The 2002 US farm bill increased assistance to cotton farmers, destroying prospects for cotton exports by west African countries, which would benefit small farmers in some of the world's poorest countries. The EU's agricultural policy, while continually the subject of reform discussions, seems resistant to major change and covers several million additional farmers since the 2004 enlargement. The principle of Community solidarity ensures that farmers in Hungary, Poland and the other accession countries will in time be treated on the same terms as farmers in France or Germany, but it is unlikely that such parity will be achieved by setting common prices (which will put many French and German farmers out of business). The consequence will be even greater difficulty for non-EU countries to export to European markets and more frequent dumping of excess produce from the European Union on world markets, to the detriment of farmers in the rest of the world.

An essential element of trade liberalisation is the gain from specialisation. Acceptance that comparative advantage shifts and that the decline of some economic activities must accompany the rise of others should be a corollary of advocating trade liberalisation.[13] Agriculture is the most salient example of OECD member country failure to accept this logic. Textiles, clothing and footwear are the other major sectors where the OECD countries, once world leaders, have been reluctant to accept the logic of changing comparative advantage. Some adjustment assistance to ease the burden of workers and owners having to adjust to structural change may be justifiable, but OECD member country textile and clothing industries were protected under the Multifibre Arrangement and its forerunners for over four decades. While rich countries' agricultural policies hurt specific developing countries (and some high-income countries) with favourable natural conditions for farming, restrictions on trade in clothing – for the most part, *the* archetypical labour-intensive manufacture – hurt labour-abundant (*i.e.* low-income) countries in general. In the Uruguay Round the rich countries agreed to phase out the MFA over ten years, but many dragged their feet and restrictions lasted until the deadline at the end of 2004.[14]

By continuing to obstruct trade liberalisation in these "sensitive" areas, OECD member countries hurt themselves. Most obviously, gains from specialisation and trade are foregone. It is a truism often forgotten in domestic trade policy debates that

protection of import-competing industries discriminates against a country's exporters; the loss of export earnings in agricultural or clothing-producing countries represents a loss of market for exports from OECD countries. Protection of food and clothing producers and foregoing the benefits of cheaper food and clothing is a political decision, perhaps based on a desire to provide support to farmers or low-wage workers in depressed regions, but more likely in response to lobbying by special interest groups with more political power than consumers or would-be exporters. Although the political economy of trade barriers has been extensively analysed and documented, outcomes are not inevitable. As Chapter 4 shows, some OECD countries have made greater efforts than others towards achieving policy coherence for development, and that involves resisting vested interests' lobbying for incoherent polices.

A higher profile cost has been the impact on non-OECD countries' attitude towards WTO negotiations. Although the high-performing non-OECD countries have all benefited from access to OECD markets, there is still a widespread belief that the global trading system does not offer a level playing field. Continuing protection of agriculture and industries which the OECD countries identify as "sensitive" feeds this view, and makes the non-OECD countries less amenable to bargaining on new trade issues. Thus, the attempts by OECD member countries to bring topics such as investment protection, competition policy, transparency in government procurement and trade facilitation[15] into the Doha Round negotiations are being stymied by a response from developing countries that they want reform of agricultural trade first. In sum, if OECD member countries want co-operation from the rest of the world on issues of importance to OECD exporters (such as IPRs), then there is a need to co-operate on issues of importance to the non-OECD countries – and not to allow negotiations to be held ransom by small but powerful sectional interests.

The evidence from the last half century is that the world is well served by a non-discriminatory liberal trade regime. The majority of developing countries has now come to recognise that trade is good for development. A major example of lack of policy coherence for development is that the OECD member countries, which created and benefited from the GATT/WTO system, now undermine that system by devoting their energies to bilateral rather than multilateral trade negotiations and by refusing to acknowledge that trade rules should apply to areas in which comparative advantage has moved from rich to poor countries.

Policy coherence for development ... beyond trade and aid

When OECD member countries became involved in development assistance in the late 1940s and 1950s, the prevailing thinking on development emphasised increased capital formation as the key, and almost only, driver of development. Half a century later, it is clear that successful development is affected by a far broader range of OECD member country policies than the aid budget alone. As OECD Secretary-General Donald Johnston has put it:

> There has been a widespread failure of the development community over many years to identify, adapt and apply the policies and insights within their governments and within the OECD that could spur development. It is now accepted wisdom that development cannot be a matter only of roads and bridges, or schools and hospitals, but must also be built on a policy environment founded on the rule of law, and institutions that enable businesses and the economy to flourish. (Johnston, 2004)

In sum, development assistance needs to go beyond financing development. It also needs to facilitate human capital formation, good governance and good policies in poor countries, as well as ensure that OECD member country policies do not inadvertently harm developing countries.

In recent decades, the rich countries have failed to match declarations of generosity with delivery of aid. The goal of 0.7% of GDP is met by only a handful of donor countries, and the share of rich countries' income devoted to aid has been steadily declining – from 0.33% in 1990 to 0.22% in 2000. Running at USD 50-60 billion per year, development assistance is dwarfed by OECD member country spending on agricultural support (USD 235 billion)[16] and military costs (USD 600 billion).[17] For some developing countries, aid flows are dominated not only by commercial capital flows but also by private transfers – remittances by workers in foreign countries are about USD 80-110 billion per year.[18] Moreover, the real value of official development assistance (ODA) is overstated: at least a fifth is tied (and hence reduced in value by as much as 30-40%); and it does not all go to low-income countries (a third of the total goes to middle- and high-income countries).[19]

There are some positive signs of donors increasing their aid commitments, however: DAC members committed in February 2003 to the Rome Declaration to make aid more efficient and to untie ODA. If such momentum is to be sustained, aid will need to be seen to be effective.

Whatever happens to aid flows, policy coherence for development requires that they be supported by giving development considerations a priority in the design of

other OECD member country policies. The previous section discussed the well-known cases of trade and agriculture policies. Financial flows besides ODA are important in the global economy, and Chapter 3 suggests how the international financial architecture could be reformed to promote more stable capital flows to developing countries. With integrated capital markets, macroeconomic policy decisions in OECD countries are transmitted to developing economies; Chapter 2 analyses how fiscal, monetary and exchange rate policies designed with national goals in mind can have negative consequences for development. To this already significant list of elements of PCD, the remainder of this section will add brief analyses of how OECD policies can promote and reward good governance and policies; how immigration policies affect development; and touch on issues related to knowledge transfer, the global commons and global externalities.

Promoting and rewarding good governance and policies

The overwhelming evidence is that aid has had only conditional success in promoting development and alleviating global poverty. Where poor countries pursue good policies, foreign aid can help them grow more quickly, but where bad polices are in place aid is money down the drain. Today's highly indebted countries have, for the most part, a long-standing record of poor policies and addiction to debt, raising the dilemma that debt relief without regime change feeds the addiction. Even worse is the possibility that aid has in some countries created a rent-seeking mentality, so that bad policies have grown worse due to aid-dependence. These outcomes contributed to aid donor fatigue in the last decades of the 20th century, but it is now widely recognised that the conclusion should not be to reject aid *per se*, but rather to acknowledge that aid alone is insufficient.

What to do with very poor countries run by bad governments? ODA to such governments risks ending up in the pockets of the rich and powerful. Channelling funds to non-governmental organisations (NGOs) is a partial solution, but NGOs can become aid-dependent, spending too much effort lobbying donors and losing sight of broader objectives. In addition, in poorly run countries, NGOs are often under the sway of the government. Targeting education and health, especially primary education and healthcare as emphasised in the MDGs, is a solution which most directly helps the poor and which targets sectors typified by market failure and whose significance for growth is well-attested. Thus directed, aid could have a powerful impact on the world's poorest people and assist long-term development, but it would only be a minor component of an adequate pro-development policy package.

A fundamental issue is: *How can OECD countries encourage good policies in poor countries?* While there is no unanimity on the precise content of good policies, the general thrust is that they should be market-friendly including *inter alia* fiscal responsibility, low inflation, openness to global markets and good institutions. There is greater agreement on the nature of bad policies; OECD member countries could contribute to their demise and avoidance by co-ordinating anti-corruption legislation,[20] promoting research capability and diffusion of knowledge about growth-related policies, and by sharing best practice and expertise more broadly. The peer review process which has been so successful within the OECD is being essayed by the New Partnership for Africa's Development (NEPAD), and the OECD can offer its 40 years of experience in helping to establish the process, but because its success requires trust and confidence-building it requires a long-term perspective. Such approaches to fragile states are recognised by aid donors, and are being addressed in OECD integrity instruments which require complementary OECD and partner country PCD.

Openness is positively related to transparency and good governance. Although some developing countries with open economies suffer from poor governance, some of the worst cases occur in countries closed off from the world. Openness can be encouraged, and rewarded, by removing impediments to trade, especially trade between OECD member countries and developing countries. As emphasised above, the temptation to impose safeguard measures whenever domestic producers complain about "unfair" competition from low-incomes countries must be resisted if those poor countries are to be successfully integrated into a prosperous global economy. The commitment to PCD in the eighth MDG should entail that such trade-policy decisions no longer respond to domestic pressures and completely ignore development consequences.

Openness can also be encouraged and rewarded by facilitating the movement of capital to countries with attractive business environments. Heavy taxation can be a serious impediment to FDI, and the OECD's *Model Tax Convention* and *Transfer Pricing Guidelines* are significant steps in the elimination of "double taxation" and achieving policy coherence in this area. The arm's length principle embodied in the *Transfer Pricing Guidelines* contributes to achieving a fair allocation of a multinational enterprise's tax base among countries in which it operates, based on economic analysis, functions, risks and assets involved in the process. In the meantime, this internationally accepted standard provides a stable environment to investors and limits the risk of double taxation that could arise if countries applied differing standards. Developing countries which implement the arm's length principle see it as a powerful tool to promote the positive development contribution of multinational enterprises by ensuring that an appropriate amount of tax is paid.

Addressing migration issues

Labour mobility is the gap in the modern era of globalisation relative to the pre-1914 era. Today less than 3% of the world's population live in a country different from that of their birth, compared to 10% 100 years ago. All OECD member countries regulate immigration, and especially "economic" migration, so that the main criteria for legal migration are social (family reunion) or political (asylum). Permanent migration is often a contentious issue, and OECD member countries have been more willing to allow access to well-trained foreigners, who are likely to be less socially disruptive and contribute more to the national economy if their education has already been paid for by another country's taxpayers. Demand for unskilled labour is met by temporary residence programmes.

Globalisation is increasing the pressures for freer movement of people. The, at least temporary, free movement of business people, technicians, policy makers and others is necessary for the smooth functioning of the global economy. Concerns about security, which impose costs on such movement whether by making travel more tedious, visas more expensive or the position of foreigners less comfortable while abroad, are a subtle but deep threat to the efficiency of the global economy. Some services require the movement of people as service providers, the so-called Mode 4 of the General Agreement of Trade in Services (GATS). There may also be a perceived short-term need for labour across the skill spectrum. Skill shortages in key areas lead to gap-filling measures, such as recent programmes in Australia, Germany and the United Kingdom to allow temporary migrants to fill specific job openings. At the other extreme, the threshold of "dirty jobs" unacceptable to the native population of most OECD member countries continues to rise; these necessary but unwanted jobs are most easily filled by temporary "guest workers". The aging of OECD populations is exacerbating many of these trends, *e.g.* by reducing the growth and flexibility of the native workforce and by increasing the demand for "care workers".

The contradictory pressures between widespread distrust of long-term immigration and the needs for temporary immigrants to fill specific gaps in the labour force have not been conducive to coherent policies.[21] Enforced "temporariness" may have negative consequence if employers cycle employees in and out or if former students sit out two years in a neighbouring country before returning to their preferred destination ("brain waste"). Definitional problems undermine the transparency and the fairness of policies, and many schemes are discriminatory, in contrast to the principles of the international economy embodied in, *e.g.* GATT and GATS. Apart from the discrimination among sending countries, temporary migration schemes may depart from national treatment – to the detriment of either domestic or foreign workers. Concerns are sometimes expressed, for

example, about foreign contract workers undermining national minimum wage legislation. On the other hand, foreign workers required to make compulsory social security contributions from which they are unlikely to ever receive benefits may view this as a disguised tariff under a cloak of equal treatment.

The high degree of regulation of cross-border labour movements has inevitably led to high levels of illegal migration. Overstaying may reflect the difficulty of separating temporary from permanent migrants, but "over-stayers" might have entered on tourist or other visa categories without ever declaring that they might enter the labour force. People-smuggling has become big business although by its nature difficult to measure – the UK Home Office estimates that 30 million people are smuggled across international borders every year. At the soft end of the people-smuggling business, agencies may offer help in facilitating illegal migration and differ little from the shadier legitimate contractors of foreign labour who provide assistance with passports, visas, travel loans and transportation on exorbitant terms. At the hard end of people-smuggling dominated by criminal gangs, the fees (and the dangers) are high. An even more criminalised response to restrictions on mobility is trafficking, where some form of coercion is used for the purpose of exploitation once the migrant is in the foreign country.

The GATS negotiations highlight the definitional and enforcement problems. Services are provided through multiple modes of supply and restrictions on one mode will not only affect the ability to supply the services but will bias delivery towards less restricted modes. Intra-corporate transfers and movement of natural persons may be close substitutes.[22] Especially with IT developments, services such as outsourcing and office work can be provided either by the movement of people or the transmission of data. The choice of mode will depend on procedures for temporary movement of people and also on the IT infrastructure in potential supplying nations.

This brief survey has focussed on difficulties in achieving coherence within immigration policies, but immigration polices clearly have implications for development. The brain drain of well-qualified people is potentially harmful to the source country, but is hard to regulate – and regulation hard to justify – in a world where the best-educated travel widely and interact with their peers of other nationalities. The movement of unskilled labour is a substitute for the export of labour-intensive goods and services, and will normally benefit the sending country by reducing labour supply pressure and through remittances to family members who remain in the home country,[23] or by knowledge and skill transfer if the migrant returns home. Immigration policies are controversial, but PCD implies that the development implications need to be considered alongside other arguments.

Knowledge transfer, the global commons, and global externalities

Movement of people and capital is an important conduit for knowledge and technology transfer. Intellectual property (IP) policy is also important. The advantages and disadvantages of patent protection and its optimal length are well known, and require negotiation and agreement on the appropriate balance between rewarding innovation and spreading the benefits of innovation. Open access can be an important tool for rapid diffusion, and proliferation of patents can impede the spread of complex technologies.[24]

In their negotiating stance, OECD member countries have tended to emphasise the need to protect intellectual property, and this is the thrust of the current WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Policy makers in non-OECD countries have been suspicious of this emphasis and of proposals to extend TRIPS rules as they view it as an instrument of strategic trade policy which will deny their citizens access to new technology on inexpensive terms. Despite appearances, this is not a zero-sum game. Critics of IP policies emphasise the distribution of costs and benefits among producers and users not just in terms of shifting the balance in favour of producers, but more insidiously in providing additional tools for transnational companies to segment markets and price discriminate in ways which may be harmful to the economic development of poor countries.[25] Such practices, which may be in the interests of individual companies in OECD member countries, are likely to reduce global well-being. In the national policy arena anticompetitive polices are addressed within the framework of antitrust or competition policy, but a global counterpart is lacking. In sum, a global economy based on market mechanisms requires agreement and enforcement mechanisms to address anticompetitive practices, and these are closely related to TRIPS. A starting point for policy coherence in this area is for OECD member countries to see intellectual property rights in a broader context than simply rewarding innovators or protecting the rights of intellectual property holders. On the other hand, the non-OECD countries must also see intellectual property rights in a broader context, rather than that of simply restricting access to knowledge which could spur their economic development.

As the global village becomes closer to realisation, understanding and willingness to negotiate will become more important than imposing solutions by dint of economic or military power. The global commons provide an obvious area. Saving the whales could only be achieved by international agreement. The same applies to other endangered species in poor countries, where domestic monitoring may be too expensive, but richer countries can play a role both directly by helping the monitors, and indirectly by banning endangered species from entering their countries. Preserving rain forests is more controversial because trees lie clearly

within national jurisdictions, but if OECD member countries want a discourse with Brazil over Amazonia, then they need to also listen to Brazilian concerns. When the externalities are global and property rights non-existent, as with ozone depletion or global climate changes, multilateral institutions are essential to address the free-rider problems and, as more nations become economically developed, "multilateral" will need to be more encompassing.[26]

Policy coherence in areas of global externalities may involve calculation and dissemination of information about the true benefits to OECD member countries. The eradication of smallpox, a programme led by the World Health Organization and funded in dribbles by the high-income countries, has saved OECD member countries billions of dollars in vaccination costs; estimates of the returns to, for example, the United States from their contribution to smallpox elimination are in the range of 20 times the outlay. Measures to deal with what have become "poor-country diseases" (*e.g.* tuberculosis) are likely to also make sense even in narrow cost-benefit terms, with the huge social benefits to poor countries as a major bonus.

Conclusions and policy implications

Both as a group and individually, OECD member countries have committed themselves to policy coherence for development, an expression coined in the early 1990s by the OECD's Development Assistance Committee. The UN Declaration of eight Millennium Development Goals concluded with the need to develop a global partnership for development. The March 2002 Monterrey Consensus on financing for development referred to development as a shared responsibility, with developing countries committing to good governance, good policies and conflict resolution, and the developed countries committing to increased and more effective aid and policy coherence. In sum, policy coherence by OECD governments is not only desirable as good economic management, but is now enshrined as their side of a compact to promote global development.

Increasing global economic integration reinforces the pressures for policy coherence for development **at the international level**. For the last two centuries, OECD member countries have dominated the global economy and set the rules. In recent years, several large non-OECD countries have begun playing a more active role in the global economy. Over the next few decades it is likely that non-OECD countries' share of world GDP will increase dramatically – from the present 20% to over 50% by 2050 – as many of them, including the most populous, experience rapid growth. Changing shares in global economic wealth imply the need for greater awareness of policy spill-overs to other countries and for greater mutual accountability, transparency and policy coherence. The need to address the

aspirations of non-OECD countries to have a say in negotiating the global economic architecture will become more pressing. The cost of ignoring such aspirations will also be more substantial.

Understanding and willingness to negotiate on the part of OECD member countries will become increasingly important. This means, for example, ensuring that channels for enforcing the rights granted under international trade agreements are not beyond the reach of developing countries that sign up to them. Another example is recognising that emerging economies need policy space while they adjust to long-term pressures to integrate into global financial markets.

Policy coherence for development **at the national level** entails the need for consistency in policies towards poor countries. Official development assistance is a part of the story, but it is not the only part and the evidence of the last half century is that on its own ODA will have little impact. Coherent policies for development will encourage poor countries to adopt good policies, and allow them to reap the benefits of such actions through access to world markets for goods, capital and labour. This means that OECD member countries, in advocating trade liberalisation, need to accept that comparative advantage shifts and that the decline of some economic activities must accompany the rise of others. Such acceptance most often involves the will to resist vested interests that lobby for incoherent policies. Coherent policies will also grant poor countries, on fair and reasonable terms, access to the knowledge that underlies the high productivity of rich countries.

Policy coherence is desirable in all aspects of public policy. In this chapter, analysis of PCD has focused on six main areas – agriculture, trade policy, investment, knowledge and technology transfer, migration, and the global commons and the domestic environment agenda – in addition to development assistance policies and donor practices. The list is far from exhaustive, as the next two chapters – on macroeconomic policy and international finance – illustrate, and this underlines the pervasiveness and difficulty of achieving policy coherence. Nevertheless, even if full policy coherence will be elusive, it is unacceptable to continue to ignore the need to align the commitment to development across OECD member country polices. Even without perfect PCD, commitment to the MDGs requires, at a minimum, that an impact assessment of all policies' implications for development should be included as part of the policy decision-making process.

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NOTES

1. Richard Pomfret is Professor and Head of the School of Economics, University of Adelaide. It should be noted that the opinions expressed and arguments employed in this chapter are the sole responsibility of the author and do not necessarily reflect those of the OECD or of the governments of its member countries.

2. In the exceptional post-war circumstances of 1945 the largely undamaged US economy may have accounted for half of the global GDP. By 2000 the rich countries produced four-fifths of global output, measured at market prices. Using PPP weights, as in Figure 1.1, the share is a lower, but still dominant, 60%. Between 1977 and 2000 China's share only increased from 5% to 11% and India's from 4% to 6% but the compounding effect means that if China's high growth rates persist, the income gap between China and India and OECD countries will narrow, and China's and India's share of world GDP will increase more rapidly in the next two decades than in the 1980s and 1990s.

3. Korea, after four decades of rapid growth, has a GDP two-thirds the size of Spain's and only recently overtook the Netherlands' GDP.

4. There are regional variations, and the situation is least positive in Africa. Of the world's 50 poorest countries in 1990, almost half had lower incomes by the end of the century, and most of these are in Africa. Nevertheless, some African countries have been success stories, *e.g.* Botswana in the long term, and Mozambique, Rwanda and Uganda in recent years.

5. This is the scenario envisaged by Robert Lucas (2000), "Some Macroeconomics for the 21st. Century," *Journal of Economic Perspectives 14(1),* winter edition, pp. 159-68. Lucas's model does not accommodate the possibility of growth reversals, such as happened in the 1980s (when it could be argued that the preceding import-substituting growth was based on shaky foundations) or in Indonesia after 1997 (but that may be a temporary setback). Forecasts, made by Ian McDonald of Melbourne University and Ross Guest of Griffith University in Australia, using PPP-based GDP data, estimate a decline in the OECD countries' share of world GDP from today's 60% to 26% in 2050.

6. This could be illustrated by comparing the rate of growth of trade with that of output, but this is an inadequate measure for several reasons. Changing borders change the definition of "international" trade. Specialisation in world markets creates opportunities for greater domestic division of labour. The increasing efficiency of the traded goods sector is understated in GDP data, because the relative price of non-tradeables increases.

7. Korea has twice experienced major crises. In 1980, together with the assassination of the president and a bad harvest, the Korean economy experienced negative growth. The growth setback was largely the result of misguided attempts by economic planners to force the direction of structural change. Recognition of

limits to interventionism led to superior post-crisis policy making. In 1997-98 Korea again experienced a crisis, this time associated with adverse features of the financial sector which were addressed - and growth was re-established by 1999. Nobody willingly wants to live through a crisis, but in both these cases the crises were relatively minor setbacks in Korea's stellar long-term growth since the early 1960s.

8. Labour mobility today is in a situation similar to that of capital mobility 30 years ago, when OECD countries restricted undesirable flows (speculative short-term capital) while permitting desirable flows (such as trade credit or long-term capital flows). The burgeoning capital markets and related development of new institutions starting with the eurodollar market made it impossible to sustain regulations based on such distinctions.

9. Illegal immigration is widespread in many parts of the world, not just in OECD countries. Illegals face harassment at many levels, with limited legal protection. The continuing large flows underline the high incentives in the global economy to migrate in search of work or security, even though potential destinations try to keep the door closed.

10. One indicator of the increasing number of countries actively involved in the global system (and interested in its design) is the number of GATT/WTO members. The Protocol of Provisional Application of the GATT in October 1947 had 8 "original signatories" (Australia, Belgium, Canada, France, Luxemburg, Netherlands, United Kingdom and United States). When GATT entered into force in January 1948 there were 23 contracting parties. By the end of the Tokyo Round in 1977 there were 84 GATT members, and when GATT was replaced by the WTO in 1995 there were over 100 members. By the end of 2004, there were 148.

11. The erosion of preference margins may hurt some very poor beneficiaries, but adjustment assistance would be a more appropriate response by OECD member countries than acquiescing to requests for extension of tariff preferences, especially if this is done by not reducing MFN tariffs.

12. The US-Singapore bilateral extends to Indonesia's Bataam Island which is part of many Singaporean supply chains, but in so doing, creates internal trade barriers within Indonesia.

13. The OECD's horizontal project on *Trade and Structural Adjustment* (OECD, 2005) offers a sector-focused, forward-looking analysis of trade and structural adjustment supported by country-specific case studies from both developed and developing economies.

14. The end of the MFA was also resisted by some poor countries which feared that removal of quotas would undermine their competitive position *vis-à-vis* potential market-share winners. This is an illustration of how incoherent and complex policies can become difficult to reform because vested interests fear possible losses whereas the potential winners may not yet be identified.

15. These four areas are the "Singapore issues". Ironically, having binding agreements on, at least, the last two areas would almost certainly benefit poor countries much more than rich countries.

16. Total PSEs as estimated by the OECD for 2000-02.

17. Military spending is increasing – from 2.5% of GDP in 2001 to 2.6% in 2002 or from 2.3% to 2.4%, depending on the source (*IMF Survey*, 15 December 2003, p. 374-6). The percentage increase is small but it represents USD 40-60 billion, equivalent to the estimated additional resources needed to achieve the MDGs.

18. The average flow of remittances during the 1990s estimated by Claudia Buch, Anja Kuckulenz and Marie-Helene Le Manchec (2002), "Worker Remittances and Capital Flows", *Kiel Working Paper No. 1130*, *Institut für Weltwirtschaft,* Kiel was USD 80 billion. Anne Harrison, Vangelis Vitalis and the Rt Hon Simon Upton in "Sustaining Whose Development? Analysing the International Effects of National Policies", OECD 12th Roundtable on Sustainable Development, 18-19 November 2003, estimate the flow of remittances in 2000 to have been USD 110 billion. http://www.oecd.org/document/7/0,2340,en_21571361_33995336_34042503_1_1_1_1,00.html.

19. For the least-developed countries, however, aid is three times larger than private flows and a substantial share (7.6%) of their GDP. A DAC Recommendation to untie ODA to the Least Developed Countries entered into force on 1 January 2002.

20. Anti-corruption legislation must be co-ordinated because unilateral action by an individual OECD country against businesses engaging in corrupt practices in foreign countries will be met by the response that the businesses' competitors gain competitive edge by getting away with such practices.

21. The distinction between temporary and permanent migration is often harder to enforce in practice than on paper, because we are dealing with people. Temporary workers may become entranced by their new residence or by one of its residents, and then repatriation at the end of the work contract may involve breaking up families. Although construction work and care services require unskilled men and women, some of these workers will acquire skills and become tradespeople or nurses, perhaps fitting a category of desired workers in an area of skill shortages. The history of Germany's *Gastarbeiter* programmes in the 1960s illustrates the difficult social and economic decisions raised by temporary worker programmes.

22. Commitments with respect to intra-corporate transfers under GATS are already fairly liberal, permitting longer stays (*e.g.* three years in Canada, the European Union and the United States, and four years in Australia) and are often not subject to economic needs tests. On the other hand, they are more easily enforced than movement of individuals because the corporations are easier to punish for transgressions.

23. Remittances from workers abroad have become a significant financial transfer to many developing countries, despite the high transaction costs (estimated to average 13% by D. Ratha [2003], "Workers' Remittance: An Important and Stable Source of External Development Finance", *Global Development Finance: Striving for Stability in Development Finance,* World Bank, Washington, DC), which often accrue to rich country institutions like Western Union because home country financial institutions are inefficient or untrustworthy.

24. If too many patented technologies or inputs are necessary for developing a new product, then a tragedy of the anti-commons may ensure the new product is stillborn. Development of GoldenRice®, a genetically modified rice with great potential health benefits, for example, required about 70 pieces of IP dispersed among different owners who needed to be persuaded to permit use of their IP before the project could proceed.

25. These arguments are presented in the September 2002 Report of the Commission on Intellectual Property Rights, *Integrating Intellectual Property Rights and Development Policy* (a report by an expert committee assembled under the aegis of the UK Department for International Development). The report is reviewed by Keith Maskus in the *Journal of International Economics 62(1)*, January 2004, pp. 244-46.

26. Jeffrey Frankel, in his survey "The Environment and Globalisation" (*NBER Working Paper 10090*, November 2003), concludes that "fears that globalisation necessarily hurts the environment are not well-founded" and when "environmental problems spill across borders … multilateral institutions are needed".

CHAPTER 2

MACROECONOMIC POLICIES: NEW ISSUES OF INTERDEPENDENCE[1]

By Helmut Reisen, Martín Grandes and Nicolas Pinaud

The era of unidirectional impacts of OECD country macroeconomic policies on developing countries is past. The emergence of China and India in the world economy is ever more evident. Cross-border financial links are ever more intense and leveraged. Trade and production are ever more integrated between OECD and developing countries. Recognising that policy coherence today cannot ignore macroeconomic interdependence, Chapter 2 surveys the most important linkages and the variables that shape interactions between OECD and non-OECD areas. In terms of the new issues and challenges of interdependence, it first analyses the impact of China as a major player in the global economy, including possible effects of a slowdown in China's growth. Secondly, it analyses the implications and mutual repercussions of growing financial integration, including new risks and benefits. Finally, it assesses the consequences of the enormous build-up of foreign currency reserves in emerging market economies, especially those of Asia. Implications of these new challenges for OECD country policy and policy mix are presented.

Preface[2]

Interdependence is on the increase at the global level. Whereas small, poor and underdeveloped states have been traditionally dependent on developed and industrialised economies, globalisation is undermining the idea that such dependency conditions are static. On the contrary, goods, capital, enterprises and people are on the move. New actors are emerging on the global stage, creating new sources of comparative advantage; they are sweeping away traditional locational advantages, thus increasing the vulnerability of economies and social groups which fail to adjust rapidly to the new realities.

Policies and policy makers will also need to adjust. Market forces alone cannot restructure the productive base, raise investment in capacity building or reform institutions. The growing influence of the global market requires the systematic and sustained promotion of mutually reinforcing policy actions on the part of both OECD and developing countries, *i.e.* systemic coherence in policy making.

This chapter argues that policy coherence cannot be improved without due attention to macroeconomic interdependence. First and foremost, as shown in the preceding chapter, the list of key players on the global macroeconomic scene is expanding, in particular through China and India, but increasingly through Brazil as well. Key global commodity and manufactured prices, wages, exchange rates and interest rates are no longer determined in OECD countries, but frequently outside the OECD area. Second, intensified financial integration and the rising leverage of institutional investors raise the amplitudes of global credit cycles, creating volatility and liquidity risks for the world economy. Third, Asia's dollar peg and its rising official reserves strengthen its role as a price setter in global financial and goods markets. These developments have an immediate impact on poor countries, both positive and negative, which is still poorly understood.

The analysis outlined in this chapter responds to some of the OECD's concerns about the effects of the new macroeconomic linkages in the global economy and the search for adequate policy responses to them. This chapter also reveals information and challenges that are important for developing countries and regions themselves. It represents an important contribution to our knowledge of the effects of interdependence and policy coherence on the relationship between OECD countries and the developing world.

Introduction

The emergence of China and India in the world economy is ever more evident, cross-border financial links are ever more intense and leveraged, and trade and production are ever more integrated between advanced and developing countries. It is high time to review how macroeconomic policies interact with each other between OECD and non-OECD countries.[3] The period of simultaneous macroeconomic stimulus in the United States and China seems to have come to an end, and new policy challenges are arising (challenges that have been perceived so far mainly in the financial community). These policy challenges call for the attention of macroeconomic policy makers, financial regulators, trade officials, energy experts and the development community. To be sure, they require an understanding of the complex issues of interdependence before they can be properly addressed. Policy coherence today cannot ignore macroeconomic interdependence.

Consider what happened in early 2004. The accommodative stance of the US Federal Reserve and the Asian central banks, in conjunction with active fiscal policies in some key OECD countries, boosted virtually every asset class just about everywhere. With rising official reserves in Japan and China absorbing US Treasury bills, spreads on emerging market bonds shrank to levels unheard of since the lead up to the Asian crisis in 1997. Raw material and energy prices boomed to unprecedented levels, lifting the corresponding currencies. For the typical capital- and raw material-dependent developing country, the mix of external conditions – high growth in the United States, high raw material prices and expansive macroeconomic policies in the G7 countries with low short- and long-term interest rates – was as good as it could get.

The outlook changed in April 2004 when the US Federal Reserve and China's monetary authorities simultaneously started to guide financial market expectations towards a period of monetary tightening. Since then, raw material prices (excluding energy) and the corresponding exporter currencies have closely reflected market expectations about the monetary policy stance in China, just like long-term rates in the G7 countries, and spreads on emerging market bonds. After benefiting from China's emergence and corresponding growth rates, observers have now started to worry about the fallout of China's possible landing, whether it be hard or soft, to lower growth.

Asia's economic catching up has made issues of interdependence much less unidirectional than they were in the early 1990s. The mutual repercussions of policy actions have thus gained in importance. Since the creation of the OECD, policies in Japan, the United States and the European Union have shaped key global macroeconomic parameters – *e.g.* interest rates and raw material prices – while

policy moves outside the OECD area have had only limited global impact. Increasingly though, policy changes – both expected or real – in China and in other big non-OECD countries have immediate and sometimes strong global effects on the world economy. How these effects materialise, is what this chapter considers.

First, this paper will present a short literature review and then a roadmap of policy challenges which might be further investigated. The focus is on a select number of *macro parameters – e.g.* monetary indicators, terms of trade, raw material and energy prices – and *country features* – net debt/reserves positions, raw material/energy net export position and China trade exposure. These macro parameters and country features seem of immediate policy relevance to three novel macroeconomic *policy challenges*:

- The macroeconomic implications of China's emergence.
- Liquidity, investor risk appetite, financial regulation and crisis vulnerability.
- The interaction of Asia's foreign exchange regime with monetary policy in the OECD area.

Before these challenges are discussed in turn, a quick tour of the literature on macroeconomic interdependence will be useful in providing methodology and perspective.

A mini survey of thinking on macro links

Interdependence used to be perceived as being between the centre – the "North" – and the periphery – the "South". The centre provided manufactured goods and capital, the periphery raw materials; growth interaction was unidirectional, from the North to the South; in the South, growth was constrained by domestic savings and investment, whence the need for foreign capital, and by a limited domestic consumer base and low skills, thus the need to stimulate growth through foreign trade. Those were the days of the two-gap approach, pioneered by Chenery and Strout, and of the trade-as-an-engine-of-growth paradigm, emphasised early on by Ricardo, Nurkse, Haberler and Lewis. While these theories retain much of their truth, those days are long gone and these theories are now inadequate (for a survey, see Currie, Muscatelli and Vines, 1988).

The oil shocks and commodity price inflation of the 1970s and 1980s and related debt problems led to greater emphasis in the literature on the role of short-run and financial aspects of North-South linkages, with policy formulation concerned with how best to respond to the oil supply shock. In the mid-1980s,

strong US recovery (sucking in imports from developing countries) and corresponding high real interest rates (a burden to debtors) and a strong US dollar (depressing raw material prices) proved a mixed blessing to the non-OECD area. Two important papers, emphasising interest rates, exchange rates and terms of trade, analysed the respective cash flow and welfare effects in a general-equilibrium framework (Dornbusch, 1985; van Wijnbergen, 1985).

The 1980s literature had still focused on the unidirectional impact of OECD macro policies on the "South". Improved domestic policies, including more open trade and exchange regimes, closer financial linkages and a corresponding rise in capital flows, a marked rise in intra-regional trade, and greater diversification of the exports of the "South" explain why the traditional trade-based business cycle linkages between the "North" and the "South" have changed (Hoffmaister, Pradhan and Samiei, 1998). Recent work on North-South linkages emphasises the increasing importance of the South for growth in the world economy and the increasing importance of financial relative to trade linkages (Currie and Vines, 1995; for the Asia-Pacific region, see Hsiao, Hsiao and Yamashita, 2003). Divergences in demographics between OECD and non-OECD areas also tend to impact on key macroeconomic variables, but they operate in the long term rather than in cyclical short-term frequency (Turner *et al.,* 1998; Reisen, 2004).

The bi-directional nature of macroeconomic interdependence has now been sealed with China's rapid growth and its integration into the world economy. Recent concerns about a possible "China shock" (see the section on the China effect below), centring on worries about energy prices, US Treasury yields, and China's import growth, show to what extent the balance of direction has changed in the macroeconomic interdependence between world regions. India, whose population number UN population experts predict will exceed China's more than 1.2 billion people in the coming decade, has started later to open up to the global economy, but is bound to reinforce the global effects already seen to flow from China.

The general-equilibrium analysis of the 1985 papers by Dornbusch and van Wijnbergen are still useful to structure research on macro links in that they focus on how *key policy variables* meet *key country elements* to shape final, endogenous outcomes for growth and welfare. Their models emphasise the role of relative prices, neglected in earlier structuralist analysis of North-South links, as these shape macroeconomic variables and welfare in the developing world. Terms of trade (the relative price of manufactured goods and raw materials), real *internal* exchange rates (the relative price of manufactures and of home goods or services), and the relative value of the US dollar and world real interest rates (deflated by nominal devaluation relative to the US dollar) are highlighted as price variables. Translated to current policy concerns, consider Table 2.1 in the spirit of these 1985 papers. The table may

help to gain immediate insights about the impact of a slowdown in raw material prices (which would likely result from a China slowdown) and a rise in OECD interest rates (which could result from a lowered build-up of China's foreign exchange reserves that have largely been invested in US Treasury bills).

Table 2.1. **Selected key country elements**

Net foreign debt/assets **Raw materials trade position**	**High net debt**	**Medium net debt**	**Low net debt**	**High net foreign exchange assets**
Net exporter	Brazil	Australia	South Africa	Norway
Net importer	Turkey	India	European Union	Japan

Source: Authors.

The country examples in Table 2.1 illustrate that the impact of a China slowdown would be uneven. It is likely that various outcomes on macroeconomic variables may deviate considerably from what partial-equilibrium analysis would predict. Assume that a China slowdown would reduce raw material prices and the pace at which China buys US Treasury bonds as official reserve growth slows, hence raise the US Treasury bond yield. Japan, for example, while heavily exposed to China through manufactured exports, would nevertheless enjoy positive effects from a China slowdown, as raw material and input cost drop (and reserves earn higher interest income); Brazil, by contrast, is likely to suffer unambiguously from a China slowdown, resulting from Brazil's net debt position and as a net raw material exporter on which higher interest rates would have to be paid just while raw material prices drop. For Turkey, another highly indebted country, the impact of a Chinese slowdown would be ambiguous as higher interest rates are attenuated by the beneficial impact of lower prices for raw materials of which Turkey is a net importer. Likewise, the impact of a slowdown in China's output growth will be ambiguous for the other countries serving as examples in Table 2.1.

Empirical evidence on the significance and size of macroeconomic interactions between OECD and non-OECD areas has been discussed and collected by Frankel and Roubini (2001), Reinhart and Reinhart (2001), and Chinn (2004). The initial emphasis on international trade, through variations in external demand, internal exchange rates and terms of trade, had been followed by a heightened emphasis on capital flows subsequent to *de facto* financial opening in many developing countries. While trade and capital *flows* are essential in propagating international links, the

speculative currency attacks of the 1990s have raised the awareness for the importance of *stock* imbalances (between real cash balances, short-term debt and official reserves) as well as currency and maturity mismatches in private and public balance sheets (Calvo and Mendoza, 1996). In the wake of the Asian and Latin American financial crises, a country's "balance sheet" in terms of currency and maturity (mis)matches of asset and debt *stocks* has been emphasised recently as an important channel for the transmission (and remission) of macroeconomic shocks. This *stock channel* complements the traditional *flow channels* of short-term macroeconomic interdependence – trade and finance *flows*.

It is not the intention of this chapter to review all the linkages that the literature has been able to identify and quantify; suffice it to mention the most significant *shock elements* and *country elements*. The literature identifies as most important and significant macro variables from the "North" gross domestic product (GDP) growth (through trade and raw material prices), interest rates (as they push or pull capital flows), and variations of key currencies (impacting on relative competitiveness and on raw material prices). The most important "South" variables that shape macro interactions are the income elasticity of its exports, the share of exportable relative to non-tradable production, the degree of raw material dependence, and the level and currency mix of foreign debt. Interest rates are relatively more important to Latin America than to Asia; OECD GDP growth is relatively more important for Asia than for Latin America; global trade and finance links with Africa have been too small, except for raw materials and oil, to find an important place in the empirical literature on macroeconomic interactions between advanced and developing countries.

Four major *macroeconomic shocks* or impulses can be distinguished:

- *Cyclical variations in GDP growth*, which trigger output/demand effects, changes in a country's terms of trade and capital flows.
- *Monetary impulses*, which determine in turn investor risk appetite, interest rates and yield curves, and capital flows.
- *Fiscal impulses*, which act similar to monetary impulses plus through crowding out of private investment.
- The *degree of G3 volatility*, that is of key currencies, interest rates and output.

Country elements determine how macroeconomic impulses impact on economies through:

- Their net asset and net debt positions in foreign exchange.

- Trade flows, via openness to trade, income elasticity of main exports, and raw material dependence.
- Foreign capital flows, notably debt flows (bond and bank credit) and foreign direct investment.

Cyclical growth fluctuations, or variation in output gaps, connect country groups through various channels: foreign demand (through exports and imports), changes in relative prices (terms of trade), and capital flows (through prospective returns on capital). Chinn (2004) finds for the period 1980-2003 the correlation of real GDP growth rates between G7/advanced countries and all developing countries significant and higher than 0.5. He also finds that for the group of the Asian newly industrialised economies (NIEs), the respective correlation is close to 1. This suggests the importance of trade links for the propagation of business cycles. However, terms-of-trade effects have also been found to be a significant channel as the elasticity of commodity prices with respect to world industrial production has remained high.

The terms-of-trade effects of output fluctuations are closely linked with fluctuations in raw material prices. As in Dornbusch (1985), a *fall in the world real price of commodities* will mean lower terms of trade for the net raw material exporter nation. This results in lower real income, the effect of which dominates the positive impact on lower factor costs and increased local supplies of both manufactures and services (due to a gain in external competitiveness in manufacturing as the real price of manufactures declines, and a real currency depreciation as the real price of home goods drops). By contrast, the raw material importing country will enjoy improved terms of trade and higher real income. As a result, demand increases for all goods, raising the full-employment real prices of both home manufactures and services.

Higher growth prospects in the capital-rich countries may stimulate foreign direct investment (FDI) and equity flows, as lower equity cost (which may result from higher stock-market valuations) stimulates equity investment abroad. Debt flows, by contrast, to non-OECD have been shown to be negatively associated to growth in the OECD area as low OECD asset returns push capital towards emerging-market debt. Following Calvo, Leiderman and Reinhart (1993), whether capital flows are "pushed" by low cyclical asset returns[4] or whether they have been "pulled" by deregulation, opening of capital accounts and privatisation in developing countries, has been discussed intensively.

A *rise of interest rates in the OECD area* will affect a majority of non-OECD countries negatively; the net debtors directly as their disposable income is decreased,

and the raw material exporters indirectly as reduced output prospects and higher storage cost lead to lower raw material prices. Net debtors are likely to experience a further burden to the extent that the level of OECD area rates also tends to raise the spreads for emerging market debtors (Frankel, Schmukler and Serven, 2000; Sløk and Kennedy, 2004). These effects will result in lower investment and growth in a large part of the non-OECD area, with negative repercussions for the OECD area.

US Federal Reserve interest cycles and spreads on emerging market bonds (EMBI+), debt-related flows, variations in investor risk appetite and emerging market crises seem to be closely linked (Kumar and Persaud, 2002). Low US rates push hard-currency debt flows towards emerging markets, high rates suck them back towards safe havens. As liabilities grow in dollar, yen and euros, mismatches in the balance sheets of emerging market private and public sector have often developed, in particular when the Fed has kept interest rates lower longer than in a typical cycle. Sløk and Kennedy (2004) provide significant evidence that the G3 monetary impulse (M2) is an important explanatory variable for the EMBI+ spread (the yield difference of emerging market bonds over US Treasury bonds),[5] although country-specific factors remain an important determinant of EMBI+ spreads (for South Africa, *e.g.* see Grandes, Peter and Pinaud, 2003).

When leading central banks cut interest rates, they tend to decrease debt cost and cause more capital to flow into emerging markets. The inflow boosts economic performance in the emerging economies, which increases optimism and triggers more capital inflows. The financial system in emerging economies does not price risks well (*e.g.* little long-term financing), the positive economic impact of capital inflow is exaggerated and, hence, the optimism of foreign investors that drives the capital inflow is also exaggerated. This is a bubble phenomenon, which has been well explained by the financial instability hypothesis (Minsky, 1991). When the Fed reverses its policy, the bubble bursts.

The *fiscal impulse* has been rather neglected in the empirical literature on macroeconomic linkages, although it has been at the core of concerns in the analytical papers by Dornbusch (1985) and van Wijnbergen (1985). The International Monetary Fund (IMF) *World Economic Outlook* (2004) provided an excellent analysis of what is at stake: an expansive OECD fiscal policy tends initially to raise world output as disposable income and, through the fiscal multiplier, world demand. Van Wijnbergen shows that, with no crowding out (as the private sector raises savings to satisfy debt neutrality), interest rates may even fall initially but terms of trade in developing countries worsen. This results from the incipient excess demand for OECD goods, as the higher public spending falls disproportionately on OECD home goods and as income is shifted from low net savers (non-OECD) to high net savers (OECD area). Should, however, the private

sector fail to accommodate higher fiscal deficits with higher savings, crowding out occurs and interest rates rise immediately, putting a burden on developing country debtors through higher interest rates, and if these trigger a higher US dollar, on the local currency equivalent of debt stocks.

In any case, at some point OECD public debt rises to such an extent that a withdrawal of the initial fiscal stimulus and higher real rates of interest are likely to result (IMF, 2004). This has important effects on balance sheets in developing countries through the "financial accelerator effect": rising real rates of interest reduce both domestic demand in developing countries and the value of collateral that backs their liabilities. In response, spreads on new loans rise, which, in turn, leads to cutbacks in new debt and investment. Likewise, a fiscal impulse can lead to an appreciation of the US dollar, in particular in connection with tightened monetary policy. This tends to worsen corporate balance sheets in developing countries if debt is dollar-linked while receipts and assets are more in local currency (currency mismatches, the "original sin" phenomenon).

Finally, *G3 volatility in interest rates, exchange rates and output* will impact through balance sheets, trade and financial flows to developing countries and back. Reinhart and Reinhart (2001) provide a highly relevant analysis for any exchange-rate agreement on a global scale. *Fluctuations between key currencies* – the euro, the dollar and the yen – impact developing (and other) countries through various channels:

- Balance-sheet effects, notably where financial-market limitations do not permit the avoidance of currency mismatches ("original sin").
- Changes in competitive positions as many developing countries peg their currency implicitly or explicitly to the dollar or the euro.
- The independent impact of dollar strength/weakness on raw material prices, and hence on the terms of trade.
- (Excess) FDI which is motivated by the avoidance of key currency fluctuations.
- Variations in debt servicing cost, which in turn feed back to the capacity to incur new debt.

With full capital mobility, a potential commitment on the part of the G3 authorities to dampen G3 currency fluctuations requires willingness to subject monetary policy to the end of currency targets, resulting in a more unstable monetary supply and more interest volatility than under freely floating exchange rates. This in turn would destabilise output in the G3 countries, with respective

consequences already discussed above. Whether a non-OECD country is a net beneficiary of G3 exchange rate targets would then depend on its trade openness, raw material dependence (either as exporter or as importer), and the level of foreign currency debt. Reinhart and Reinhart (2001) produce simulations to conclude that Latin America typically benefits (in the form of higher GDP growth) from low interest rate volatility, while key currency fluctuations matter less; the Asian NIEs benefit disproportionately from lower volatility between G3 currencies; other developing countries need both stable key currencies and stable G3 consumption expenditures to maximise their GDP growth.

From this mini survey, some preliminary policy lessons can be drawn. First, given the importance of balance-sheet effects, the avoidance of emerging-market crises requires consideration by leading OECD countries of their macroeconomic policy mix on exchange and interest rates; this does not imply the need for exchange-rate target zones, as they may be counterproductive. Second, debtor non-oil developing countries benefit most from a combination of strong OECD growth, low real interest rates, and a weak US dollar. A policy mix as experienced in the early 1980s, therefore, with tight monetary policy and loose fiscal policy that led to rising interest rates and a strong dollar, is harmful first to the developing world, and given the intensified global links, is bound to backfire on the OECD area.

New issues of macroeconomic interdependence

The China effect

Policies matter. The prospective slowdown in China is one of the key sources of uncertainty in the world economy. Can the Chinese authorities engineer a soft landing, or will it be hard? The concern, formulated in the financial instability hypothesis (Minsky, 1991), is that over a protracted period of high growth, economies tend to move from a financial structure dominated by self-finance (*e.g.* retained earnings) to highly leveraged firms and individuals. Further, China's dollar peg – while stimulating the country's global integration – denies the world an important policy variable –currency adjustment – to address global imbalances; pegs, even when "hard", have repeatedly been seen to raise the vulnerability to speculative currency attacks. The major lesson of the 1997-98 Asian crisis is to avoid currency pegs and to allow exchange-rate flexibility to buffer the monetary system of developing countries against pressures arising from financial flows into and out of the economy. China's dollar peg, furthermore, leverages US monetary policy disproportionately as China is big and growing.

Size matters. China's population, accounting for 20% of the world total, is several times larger than that of Japan and the "Asian tigers" combined. Since 1980, China has grown faster for longer than any country in history. By 2003, China's economy, with a GDP of over USD 1.4 trillion, accounted for 55% of Asian exports. Japan's economy has recovered largely with a crucial boost from rising net exports – a substantial portion of which have flowed to China. What little growth the German economy has experienced over the past two years is derived from rising exports, again, primarily to China. Likewise, rising exports to China have helped to lift US growth at a time when substantial excess capacity existed in the aftermath of the 1990s overinvestment boom. By 2003, China had evolved as a major contributor to global demand growth. China's open economy accounted for 7.2% of world imports while accounting for 16.5% of global import growth (for detailed information on China's recent impact, see IMF, 2004).

Marginal demand matters. In view of its *share* in global economic aggregates, the common perception of China as a heavyweight of the world economy may be deemed excessive: at market exchange rates, the country makes up "only" around 4% of world GDP while accounting for 20% of the world population. Yet, average shares in world aggregates, be it GDP or trade, do not tell the full story. Seen from a dynamic and comparative perspective, China already stands out as a major player in the world economy. China is now the sixth largest economy (at market exchange rates) and the fourth largest trader in the world. The United Nations (UN) (2004) estimates China's contribution to global economic growth at about 15% in 2002-03.[6]

Meanwhile, Asia has become ever more "China-centric": China alone accounts for 18% of south and East Asian trade. A vibrant domestic growth has turned China into one of the main outlets for Asian exports. Between 1998 and 2002, China's imports have been critical to the growth of neighbouring countries' exports. The growth of exports to China alone has prevented Japanese exports to the world from dropping: Japan's former dependence on the US market has been added a second major pillar with China's imports. Moreover, China accounted for 46.8% and 78.3% of export growth in Korea and Chinese Taipei respectively over the same period, according to International Trade Centre (ITC) data.

Although its external economic ties remain undoubtedly concentrated in Asia if measured by trade flows, China has also become the largest marginal consumer of many raw materials and energy products, with a strong link to raw material, food and energy providers in Africa, Australia and Latin America. Growth in China has been driven by booming investment (exceeding 40% of GDP), which has been itself related to commodity intensive processes of industrialisation, urbanisation and infrastructure construction. Alongside soaring demand for housing and cars, the investment trend has helped drive Chinese imports of raw materials up to record

levels. Chinese shares in global materials' trading have skyrocketed. Considering that China is still in the early stages of "economic catch up", the "hungry dragon" is likely to become "voracious" in the medium/long term.[7]

A prospective slowdown in Chinese demand growth should, in principle, also trigger a sharp fall in commodity and energy prices (see Table 2.2). Contrary to Pomfret's (1997) assessment that China is a price-taker (in trade economics jargon: a small country) in raw material, food and energy markets, the country may now (based on data ten years on) be regarded as a price-maker on some international commodity and energy markets. China's impact can be as easily exaggerated as underestimated as long as supply factors, speculative bubbles (including hoarding) and terror premia are not properly controlled for. This stresses the need for an econometric estimation of commodity prices' (oil prices in particular) response to *China's demand growth* momentum relative to *global supply factors*; the *Interlink* model might be usefully employed here. The analysis will have to reckon that China is partly replacing production, hence commodity and energy demand, elsewhere so that its demand should not simply be added to the existing demand on a global scale; that the convergence of living standards in Asia's giant will likely stimulate net overall demand; and that, in time, India will generate much of the incremental world demand for primary commodities over the coming decades.

China's global impact nowadays stretches not only into goods and commodity markets, but equally into world financial markets. China is not perceived just as a producer of low-priced goods, but likewise of "cheap savings" (Dooley, Folkerts-Landau and Garber, 2004). Although it is now the biggest destination for FDI inflows, China's impact on global capital markets is not so much in its demand for foreign savings. It is rather the acquisition by the Chinese official sector of large amounts of foreign assets, not least US long-term Treasury bills (as of mid-2002, China was the second largest foreign holder of this asset class, *i.e.* USD 165 billion or 6.5% of total foreign holdings), that has raised the country's global cyclical, financial and macroeconomic importance. Lower net capital flows to China, for example, might obviate the need for Chinese authorities to buy US Treasury notes for sterilisation purposes; the same would hold if the Chinese currency was floated; in turn, the US dollar might weaken, and US interest rates rise. Only a few years ago, investors gauged monetary cycles by watching the US Federal Reserve closely; meanwhile, China's macroeconomic policies are taking on almost a similar importance for short-term price movements in financial assets.

Table 2.2. **China's demand power**

Product	**China's imports,[1] annual growth in value, 1998-2003 (%)**	**Annual growth of world imports, 1998-2003 (%)**	**China's share in world imports, 1998 (%)**	**China's share in world imports, 2003 (%)**	**Ranking in world imports 2003**	**China's (net imports) share in world imports, 1998 (%)**	**China's (net import) share in world imports, 2003 (%)**
Copper and articles thereof	26.1	3.4	5.6	17.7	1	4.6	15.8
Ores, slag and ash	29.1	7.4	5.2	18.6	2	7.1	18.1
Fertilisers	-9.4	3.1	13.4	8.2	3	14.9	6.6
Textile, fibres, fabric, etc.	8.4	1.6	8.5	12.7	n.a.	4.4	5.8
Oil seed, oleagic fruits, grain, seed, fruit, etc.	37.0	7.0	4.0	19.2	1	2.0	16.0
Iron and steel	30.9	6.5	3.4	13.0	1	2.7	11.7
Plastics and articles thereof	15.4	6.7	4.3	8.7	2	3.0	5.4
Electrical, electronic equipment	30.7	7.9	2.6	9.8	2	0.0	3.5
Optical, photo, technical, medical, etc. apparatus	44.9	9.0	1.6	10.4	2	-0.2[2]	7.4
Organic chemicals	34.2	8.1	1.7	7.6	2	0.2	5.0
Mineral fuels, oils, distillation products, etc.	35.7	19.3	0.7	3.4	7	0.5	2.4

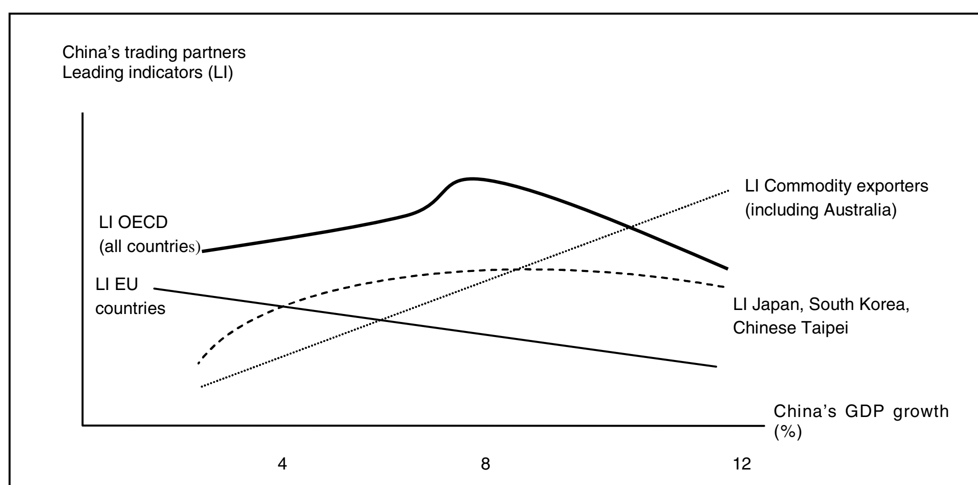
Notes: 1. In 1998, China was a net exporter of optical, photo, technical, medical, etc. apparatus.
2. Gross imports, unless specified.

Source: Authors' estimates based on ITCtradeMap data.

What impact should a slowdown of China's growth have on the world economy? To be sure, a slowdown of China's output growth would be a return to the growth of *potential output*, which is often quoted as 7% or 8% per annum. As emphasised by Baker and Jen (2004), the growth nexus is probably far from linear. The response of global activity to an economic landing in China may be seen as roughly "convex", depending on the severity of China's expected slowdown. Should the Chinese authorities manage to engineer a *soft landing* of the economy, a very limited impact on global growth is to be expected and could be positive overall. The impact on Asian countries would remain mild (the potential drop in external demand would be partly offset by lower commodity prices)[8] while non-Asian OECD countries would benefit from lower commodity prices and suffer limited impact on their export sectors. Commodity exporters (Australia, Argentina, Brazil, Russia) would be the main losers, but even the latter would record limited losses (a Chinese soft landing alone is unlikely to reverse the long bet on commodity forward markets).

In contrast, a Chinese *hard landing* would, in theory, be very costly from a global growth perspective (see Figure 2.1). The impact of a collapse of China's economic activity would be mostly and strongly felt by Asian neighbours and commodity exporters. Those OECD countries which are the more exposed to China (the exporters of capital goods) might also be affected. It may be assumed that their losses would largely exceed other countries' gains stemming from lower commodity prices.

Figure 2.1. **The "convex response" hypothesis**



So far, the prospect for a soft landing looks good. Industrial output growth, one of the key indicators of overheating, has declined to 15.5% in the year to July 2004 and is on course to reach 12% by the end of 2004. This is a far cry from the unsustainable 23% annual rate recorded in February 2004.

Financial interdependence: new rules, new actors, new risks and benefits

Next to the rise of China and India in the world economy, it is the growing financial integration[9] of countries recently closed to global financial markets which makes nationally oriented macroeconomic analysis increasingly meaningless and policies ineffective. The recent wave of financial globalisation since the mid-1980s has been marked by a surge – and subsequent reversals – in private capital flows to the so-called emerging markets, mostly in Asia, Latin America and central and eastern Europe (see Table 2.3). True, almost all private capital flows have gone to not more than about 20 developing countries, but these countries cover 90% of the developing country population.[10]

Table 2.3. **Net private flows to emerging markets**
In USD billions

	Annual average 1990-2000	**Annual average 1995-1996**	**Annual average 1997-2000**	**Annual average 2001-2003**	**2003**
Emerging markets total*	111	218	69	99	171
- Direct investment	76	102	148	129	76
- Portfolio investment	50	72	26	-16	29
- Other private (banks, etc.)	-15	44	-105	-15	66
Memo: current account balance	-24	92	9	113	142
Foreign exchange reserves build-up	56	114	79	203	282

Notes: * China, India, Indonesia, Korea, Malaysia, Philippines, Chinese Taipei, Thailand; Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela; Czech Republic, Hungary, Poland, Russia, Turkey; South Africa.

Source: Bank for International Settlements (BIS) (2004), *74th Annual Report*, BIS, Basel; BIS (2003), *73rd Annual Report*, BIS, Basel.

The first half of the 1990s saw a massive expansion of private financial flows from developed to developing countries, which was widely welcomed as a positive contribution to development. Foreign savings can be beneficial: by adding to domestic savings (rather than crowding them out) they stimulate capital accumulation; by raising the recipient economy's efficiency (*e.g.* through improving resource allocation, dynamising competition, interacting with human capital,

deepening domestic financial markets or reducing capital costs for local entrepreneurs); and by lowering consumption risks over various states of nature through enlarging choices for portfolio diversification, but also through appropriately sharing risks between capital exporters and importers. Capital inflows into developing countries fuel short-term growth, as they reduce risks of bank insolvencies (and so stimulate domestic credit) and as they raise average productivity of installed capital. Hence, swings in capital flows are costly, regardless of how they are financed.

Indeed, the second half of the 1990s revealed that these private flows could be easily reversible, as a succession of financial crises in emerging markets seriously set back important progress in economic growth and poverty reduction. Since 1994, such reversals have contributed to severe financial crises in most of Latin America, large parts of southeast Asia, and also in some transition countries. These crises were often aggravated by cross-border financial contagion, where market liquidity suddenly dried up for particular countries – not because of economic fundamentals in these countries, but because they shared some characteristics with another economy suffering a loss of market confidence. Short debt maturities, a high share of debt (both domestic and foreign in open economies) to foreign exchange reserves, high deficits on the current account of the balance of payments (as a percentage of GDP), and a pegged exchange rate raise a country's vulnerability to "speculative attacks". The large devaluations that follow are costly to growth, particularly after extended periods of capital surges, if these surges tend to fuel dollar debt relative to liquid assets, to raise the non-tradable share in the economy and to dollarise corporate liabilities.

The long series of financial crises affecting emerging market economies in the 1990s (Mexico, east and southeast Asia, Russia, Brazil) and more recently (Argentina, Turkey) also had important repercussions on advanced and developing countries. Output slumps in the crisis countries translate into lower demand for exports from OECD countries and raw material exports; portfolio investors (both equity and bonds) have seen lower returns in their globally diversified portfolios, impairing future pension returns; commercial bank lenders have been forced to write down credit losses, reducing tax receipts correspondingly; and, as the Russian crisis and the subsequent global financial turmoil has shown, emerging market crises can even put the entire global financial system at risk. The subsequent monetary easing by the leading central banks, in the absence of global lender of last resort (a task for which the IMF is undercapitalised) may cause bubbles (such as in 2000 on global equity markets) which are subsequently difficult to control and costly to rein in.

Looking forward, financial integration will proceed under new rules, with new actors and entail new risks and benefits that are still not well understood, but cannot

be ignored. To cope with emerging market crises, the international community has developed and promoted a range of voluntary international standards of good practices for economic policies and for the financial infrastructure (Reisen, 2002). While financial markets have globalised and capital flows freely, there is continued fragmentation between 200+ national jurisdictions with respect to currencies, supervision, taxes, laws and regulation (civil, commercial, bankruptcy, criminal courts). When a country becomes more globalised, its institutional, legal and other structures need to move towards international best practices if it wants to provide the appropriate market signals and information in the contest for global capital supply. The current international effort to codify best practices and to disseminate them widely should help the seamless integration of local economies into global markets, hence broadening and further intensifying the process of global financial integration.

Two international regulatory initiatives in particular seem to deserve policy attention for their potential impact on the pricing and volume of global capital flows, the first affecting cross-border bank credit and, the second, global portfolio bond flows to developing countries. The first is the new capital adequacy framework commonly known as the Basel Capital Accord *("Basel II")*, which was approved by Basel Committee on Banking Supervision and endorsed by the G10 on 29 June 2004. There is little analysis (but see Deutsche Bank, 2001; Reisen, 2001; Weder and Wedow, 2002) of whether Basel II will have an impact on international bank lending flows to emerging markets. However, sub-investment grade sovereign borrowers, still the majority among developing countries, are expected to face significantly higher bank credit costs while investment-grade borrowers are likely to benefit. Another concern related to Basel II is its possible pro-cyclicality. It is possible that the volatility of flows will increase further if ratings are explicitly used to determine capital costs. This issue is examined in detail in Chapter 3.

Second, after heated debate over the desirability of the reforms to the way that financial markets and the international community deal with sovereign debt crises,[11] efforts at strengthening the framework for crisis resolution will continue to focus on promoting *collective action clauses* (CACs) in international sovereign *bond issues*. Mexico's and Brazil's successful sale of global bonds with CACs in spring 2003 – the first placement of bonds with CACs by emerging market sovereigns into the US market – suggests that the long-held opposition to CACs in some quarters may be easing. Given the ongoing opposition of investors and some sovereigns to greater use of CACs in emerging market bonds – on the grounds that prospective emerging market bond finance would be more costly – new evidence on the way that financial markets have priced the use or non-use of CACs is policy relevant. Overall, the empirical evidence to date supports the conclusion that the use of CACs will modestly reduce funding costs for investment-grade emerging market borrowers and raise them for lower-rated countries (Kletzer, 2004). By pricing moral hazard in

sovereign debt markets, CACs could encourage market discipline. By facilitating creditor co-ordination, CACs should also reduce the costs in terms of a nation's output that are due to protracted debt restructurings.

New actors, resulting from demographic pressures and the institutionalisation of asset management in OECD countries, have probably introduced amplifiers to global credit cycles, with potentially harmful effects to both capital-importing countries and investment returns in capital-exporting countries (Bank of International Settlements [BIS], 2004a). The investor demand for peripheral asset classes, *e.g.* high-yield emerging market bonds or sub-investment grade corporate bonds, depends much on a combination of investor risk appetite and the search for yield. Both appetite and search are stimulated when asset returns in the OECD area are low (the *push factor* in Calvo, Leiderman and Reinhart 1993). The BIS *74th Annual Report* explains the refusal to adjust nominal target rates of return, among others, to institutional and regulatory constraints for life insurance companies and pension funds, whose liabilities are linked to a minimum guaranteed return (either by statutes or by contracts, but also by the market-based discount rates applied for defined-benefit schemes). To avoid funding gaps, such institutional investors are led to invest in higher-yielding, higher-risk instruments. The prospective rise in institutional savings, fed by demographic trends and switches from PAYG (unfunded pay-as-you-go) to funded pension systems, together with the need to achieve decent capital returns despite the headwinds of shrinking labour forces in the OECD area, can therefore be expected to intensify the macroeconomic effects of business cycles in both OECD and non-OECD areas.

Faced with low returns, pension fund strategy committees and individual investors have been increasingly turning to hedge funds, searching for uncorrelated asset classes with a focus on absolute (rather than benchmark-oriented) return. Hedge funds can have a significant impact on small, illiquid markets where their exposure can be heavily concentrated. Roughly 75% of hedge funds use leverage, with an average ratio of 2:1 (as measured by the ratio of loans obtained relative to equity capital) for the industry as a whole. This suggests that the industry could have as much as USD 1.5-2.0 trillion in levered assets, according to estimates by Morgan Stanley (McCaughrin, 2004). The Bank of England (2004) has recently warned that rising interest rates could provoke "financial distress" if investors decide to switch from hedge funds, high-yield bonds and other risky investments.

The 2004 spring slide and subsequent recovery in emerging market bonds provides an example of how OECD monetary policy (or merely market expectations thereof) is amplified by hedge funds and other leveraged investors. The slide was not driven by a country or regional crisis. Instead the trigger was a tightening of US rates. Emerging market debt was hit disproportionately by reflex risk aversion on the

part of investors and large-scale unwinding of speculative carry trades – borrowing at low US interest rates to buy higher-yielding assets. Once concerns over rising US rates had stabilised, emerging market bonds rallied. This reflected the improving economic fundamentals, reduced risk of contagion of problems between countries and a rising tide of liquidity seeking higher yield. By early July 2004, JP Morgan's sector index, the EMBI Global, was up 7.6% from lows in early May, while spreads over US Treasuries have narrowed from around 549 to 475 basis points. Monetary policy makers, bank supervisors and developing country finance ministers have to reckon the higher amplitudes of financial price variance introduced by hedge funds in guiding expectations, assessing bank risks and gauging borrowing costs.

Currency regimes, Asian reserves and OECD deficits

While the world's richest country is also its biggest capital importer and net debtor, emerging market economies have, notably in Asia, accumulated enormous quantities of foreign currency reserves since the Asian 1997/98 crisis. The massive build-up of foreign currency reserves in East Asian central banks, partly reinvested in US Treasury bills, prevented US long-term interest rates from rising and the US dollar from further depreciating to adjust for global imbalances. Recent evidence has documented a negative relationship between yields to maturity on long-term US Treasury bonds and official holdings of these bonds in East Asian central banks (BIS, 2004b). That much of Asia strictly or implicitly pegs to the dollar (whatever may be officially pronounced) is not new;[12] exchange rate targets have repeatedly been uncovered through detecting implicit weights for basket pegs, reserve volatility, or interest rate volatility (summarised by Branson, 2001); new is the sheer amount of official reserve accumulation (see Table 2.4).

Table 2.4. **Reserve accumulation in emerging markets since the Asian crisis**

	Foreign exchange reserves[1] In USD billions					
	1996	**2000**	**2001**	**2002**	**2003**	**March 2004**
Asia[2]	477.4	694.5	770.5	944.2	1 208.1	1 302.9
China	105.0	165.6	212.2	286.4	403.3	439.8
Hong Kong, China	63.8	107.6	111.2	111.9	118.6	123.8
India	19.7	37.3	45.3	67.0	97.6	107.2
Korea	33.2	95.9	102.5	120.8	154.5	162.7
Chinese Taipei	88.0	106.7	122.2	161.7	206.6	226.5
Latin America[3]	141.3	136.1	135.9	140.1	170.7	178.8
Argentina	17.7	24.4	14.5	10.4.	13.1	13.5
Brazil	58.3	32.5	35.7	37.4	49.1	51.6
Mexico	19.2	35.1	44.4	49.9	57.7	60.3
Central Europe[4]	40.1	51.5	51.3	63.2	72.9	75.4
Russia	11.3	24.3	32.5	44.1	73.2	79.6
South Africa	0.9	5.8	5.8	5.6	6.2	7.9

Notes: 1. End of period: for the regions, sum of the economies listed below.
2. China; Hong Kong, China; India; Indonesia; Korea; Malaysia; Philippines; Singapore; Chinese Taipei and Thailand.
3. Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
4. Czech Republic, Hungary and Poland.

Source: IMF, National Data (table initially published in BIS [2004], *74th Annual Report,* BIS, Basel, June).

In recent years, East Asia has funded nearly half of the US huge current account deficit – the other half having been financed essentially by European private capital flows; East Asian central banks are among the biggest net foreign purchasers of US Treasury bonds. The counterpart of US deficits has been a huge current account surplus run by most East Asian economies. These sizable current account surpluses have translated into a massive build-up of US dollar reserves or a sustained increase in US Treasury bill purchases on the part of East Asian central banks. The pairwise interaction between the Asian producer and the American consumer, with Asia delivering "cheap" goods (keeping US consumer price inflation down) *and* "cheap" savings (by keeping US interest rates down), has permitted an accommodating US monetary stance, with the Euro as the "residual" degree of freedom in the global monetary system. In turn, exchange-rate pegs have clearly been causing problems in Asia, not only through trade friction, but also by exacerbating the countries' accelerating liquidity growth/overheating economic growth problems.

Asia is unlikely to drop the dollar peg – explicit or implicit – as long as China does not. However, currency flotation and capital account liberalisation are not a viable option, because of China's effectively insolvent banking sector and underdeveloped financial system. Should Beijing open up the capital accounts and allow foreign banks to conduct *renminbi* business, this could create a bank run and risk a collapse of China's state-owned banks. A much recommended exchange-rate policy option has been a widening of the *renminbi*'s trading band, but this alternative is also problematic in the near term. Too small a widening would not only offer insufficient relief to the trade and liquidity imbalances, but also encourage speculation of a further widening of the band; too large a widening, on the other hand, runs the risk of the *renminbi* appreciating to levels harmful to export growth. The option of pegging the *renminbi* to a basket of currencies is another alternative that has been frequently suggested (for early proponents of Asian basket pegs, see Reisen and van Trotsenburg, 1988), but it denies Chinese firms engaged in merchandise trade to buy *renminbi* forward contracts to hedge against exchange-rate risks (McKinnon and Schnabl, 2004).

Asia's high-reserve policy and limited exchange rate flexibility have relevant implications and certain repercussions for leading OECD countries (see Dooley, Folkerts-Landau and Garber, 2004). First, Asia can now be considered a price-maker for key currencies, thanks to its "awesome" foreign reserves. Second, OECD (especially US) monetary policy cannot afford to ignore the leverage effect that the co-existence of Asian dollar pegs and the growing importance of the Asian economies introduce into the global-economy cycle.

First, while a move to more exchange rate flexibility in East Asian exchange regimes would likely drive an appreciation in their currencies, a rise in US long-term interest rates and a potential reversal in US current account deficits, it is less apparent how a rebalancing of dollar reserve portfolios held by East Asian official sector investors would affect these variables. The problem is that these official sector investors are much too large now to be price takers in foreign exchange and fixed income markets. Diversification of reserves may trigger currency volatility. This danger may also explain why Asian reserves have remained biased towards US assets. Dooley, Folkerts-Landau and Garber (2004) note that reserve diversification would have implications for foreign exchange market intervention by both the European Central Bank (ECB) and Asian central banks. If Asian central banks rebalance reserves away from the dollar, private investors will require a fall in the dollar against the euro and the ECB might feel forced to stabilise the euro/dollar rate.

Second, if East Asia is not set to allow more flexibility in exchange policies and official reserve diversification proves insufficient in bringing about a

depreciation of the US dollar against East Asian currencies, either the euro zone will have to bear the brunt of the adjustment in global imbalances through a strengthened euro or the United States will be bound to implement a set of corrective fiscal and monetary measures (Dooley, Garber and Folkerts-Landau, 2004). Monetary tightening in the United States should feed through China's domestic interest rates on a one-for-one basis, as China keeps its currency pegged to the US dollar. However, remaining capital controls and domestic sterilisation could make it less than 100% the pass-through from US to China's (and other countries') short-term rates. While in recent years, China's peg to the US dollar has been inflationary, US tightening should contribute to a slowdown in China through the peg. However, China and the United States do not form an optimal currency area (OCA): business cycles will not be sufficiently synchronised and the relevant policy parameters will not be flexible (and endogenous to the requirements of the peg) enough to avoid serious output volatility.

Summary: potential implications for policy formulation

Macroeconomic interdependence between the OECD area and developing economies is today much less unidirectional than only a decade ago, mainly thanks to Asia's catch-up. As the mutual repercussions of economic policies are gaining importance, they demand due attention by authorities. Moreover, financial links appear to be gaining importance relative to trade links, posing new challenges to our understanding of complex issues before policy can be properly formulated.

- Given the importance of balance-sheet effects, the avoidance of emerging market crises requires consideration by leading OECD countries of their macroeconomic policy mix on exchange and interest rates; this does not imply the need for exchange-rate target zones, as they may be counterproductive by raising interest and output volatility.

- Debtor non-oil developing countries are best off with a combination of strong OECD growth, low real interest rates, and a weak US dollar. The type of policy mix experienced in the 1980s, therefore, with tight monetary policy and loose fiscal policy that led to rising interest rates and a strong dollar, is harmful first to the developing world, and given the intensified global linkages, is bound to backfire on the OECD area.

- China may now be regarded as a price-maker on some international commodity and energy markets, and its global impact nowadays stretches equally into world financial markets. The acquisition by the Chinese

official sector of large amounts of foreign assets has raised the country's global cyclical, financial and macroeconomic importance.

- The response of global activity to an economic landing in China may be seen as roughly "convex", depending on the severity of China's expected slowdown. If the Chinese authorities manage to engineer a *soft landing* of their economy, a very limited impact on global growth is to be expected and could be positive overall.

- The formulation of policy options can be informed by econometric estimations of commodity price responses to China's demand growth momentum relative to global supply factors and of the impact of a slowdown in China's growth on the world economy.

- The wave of *financial globalisation* since the mid-1980s makes nationally-oriented macroeconomic analysis increasingly meaningless and policies ineffective. From an international regulatory perspective, first, more analysis is needed to assess whether Basel II will have an impact on international bank lending flows to emerging markets and whether concerns about its possible pro-cyclicality are justified, and second, efforts at strengthening the framework for crisis resolution will continue to focus on promoting *collective action clauses* (CACs) in international sovereign *bond issues*.

- The prospective rise in institutional savings, fed by demographic trends and switches from PAYG to funded pension systems, joined with the need to achieve decent capital returns despite the headwinds of shrinking labour forces in the OECD area, can be expected to intensify the macroeconomic effects of business cycles in both OECD and non-OECD areas.

- Asia's high-reserve policy and limited exchange rate flexibility have relevant implications and certain repercussions for main OECD countries. If, for example, Asian central banks rebalance reserves away from the dollar, private investors will require a fall in the dollar against the euro and the ECB might feel forced to stabilise the euro/dollar rate. If, by contrast, East Asia is not set to allow more flexibility in exchange policies, either the euro zone will have to bear the brunt of the adjustment in global imbalances through a strengthened euro or the United States will be bound to implement a set of corrective fiscal and monetary measures.

NOTES

1. This chapter was originally published on 20 January 2005 as an OECD Development Centre Working Paper [No. 241, code DEV/DOC(2005)01], written by three authors from the Development Centre at the request of the OECD's horizontal project on policy coherence for development. The original paper has been edited slightly for this volume. It should be noted that the opinions expressed and arguments employed in this chapter are the sole responsibility of the authors and do not necessarily reflect those of the OECD or of the governments of its member countries.
2. Adapted from original preface by Professor Louka Katseli, Director, OECD Development Centre.
3. As a convenient shorthand, economists call the North-South interactions which focus on short-run issues, including through financial markets, "macroeconomic" interactions, to distinguish them from the trade-as-an-engine-of-growth paradigm. Former work at the OECD secretariat dealing at least partly with macro interactions includes: the so-called Oyake Report "The Major Developing Economies and the OECD" (1988); OECD (1994); as well as Saunders and Dean (1986). The OECD report "The World in 2020: Towards a New Global Age" (1997) did not deal with macroeconomic interactions as defined here.
4. Besides structural factors such as the institutionalisation of asset management, cross-listings on stock markets, and demography.
5. After correcting for the outlier effects related to the 2002 US corporate scandals (on which see Reisen, 2003).
6. Quantitative studies of the China impact can be found in, for example: IMF (2004), Chapter 2; Yang (2003); and in Ma (2003).
7. However, estimating Chinese future demand for raw materials (and its impact on world commodity prices) based on income elasticities (themselves computed on an historical basis) is partly flawed as China is on the whole better endowed with natural resources than other Asian industrialisers. Therefore, Chinese supply-response to a rise in world commodity prices must not be underestimated (Pomfret, 1997). Moreover, China's raw materials' demand will replace the demand by other countries to a certain extent.
8. Some oil-importing Asian economies that benefit the most from vibrant Chinese imports also suffer from China's dynamism through the channel of high

commodity prices. For those countries, of which Korea is a typical example (see Lam and Xie, 2004), a soft landing of the Chinese economy would have limited fall-out on their growth momentum.

9. Prasad *et al.* (2003), in their widely quoted IMF paper, make a definitional distinction between financial globalisation and financial integration. They define financial globalisation as an aggregate concept that refers to rising global linkages through cross-border capital flows, while financial integration refers to an individual country's linkages to international capital markets.

10. It is often observed that the bulk of private capital flows cover only a handful of countries; such observation is, however, distorted by country-size bias as many poor countries receive a high share of flows in proportion to their GDP but are too small to make weight in total numbers on private flows.

11. Argentina is currently a country unable to return reasonably quickly to market financing and in need of external debt restructuring to reduce its debt servicing burden. A lack of clear rules on how to resolve unsustainable debt situations for sovereign debtors is partly responsible.

12. Targets of slightly undervalued real effective exchange rates can be rationalised in the development context: they provide a bias towards exports and may thus stimulate growth in countries where the absence of deep financial systems and distorted local prices would otherwise provide inferior signals for the dynamic allocation of resources (McKinnon and Schnabl, 2004).

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CHAPTER 3

DEVELOPMENT IN INTERNATIONAL FINANCIAL POLICIES

By Stephany Griffith-Jones, Ricardo Gottschalk and Andrew Rosser[1]

The provision of adequate and stable financial public and private financial flows to developing countries is necessary to address the poverty-reduction and sustainable development challenges of the 21st century. This requires reforms to the international financial architecture that are coherent with growth and development objectives. Chapter 3 analyses trends in capital flows and three types of public-private links to stimulate increased flows: counter-cyclical guarantees, socially responsible investment, and proposals for an international finance facility. It examines the impact on capital flows to developing countries of a current proposal to modify banks' regulatory capital, known as Basel II. Based on an assessment of the political economy aspects of incoherence in the international financial architecture, it pinpoints specific challenges for OECD member countries and concrete ways forward, including movement to representation of developing countries in the financial governance system that accurately reflects today's economic and political realities.

Introduction

The currency and financial crises of the late 1990s generated a broad consensus that fundamental reforms in the international financial system are needed to address the challenges of the 21st century appropriately. The rationing of private capital flows to poor countries, even when such flows are booming to emerging countries; the drastic reversals of capital flows that trigger crises; and the drought of private flows to all developing countries following the Asian crisis imply that, besides the objective of international financial stability, an equally important objective is the provision of sufficient and sufficiently stable private and public flows to different categories of developing economies. For the international financial system to be coherent with development it must both: *(i)* prevent developmentally costly crises and better manage them when they do occur; and *(ii)* support adequate net private and public flows to support poverty reduction and sustainable development. Whilst much of the international discussion has been on the first point, much of this chapter will focus on the second.

This chapter aims to explore certain options for reform that are being debated by the international community which, if adopted, could considerably improve development policy coherence of OECD member countries – and thereby contribute to meeting the challenges mentioned above. It focuses on new forms of encouraging more and more stable private and public flows to developing countries, involving public-private linkages, so that these countries can grow faster and reduce poverty, thereby moving closer to achieving the Millennium Development Goals (MDGs). It also discusses key obstacles to reform and the challenges for overcoming them.

The next section provides a brief background analysis of recent trends in capital flows. The purpose is to show that these flows, although starting to recover from the extremely low levels seen since 1998, may still be easily reversible. This calls for further reforms in the international financial architecture (IFA).

The subsequent section seeks to assess how much progress has been made and argues that, to date, it has been limited. It suggests areas in which further advances are needed. In particular, it highlights the need for more vigorous action for implementing the Monterrey Agenda on development finance, which includes a range of options for encouraging more and more stable capital flows to developing countries, as well as the need for more developing country representation in international fora. The chapter addresses the issue of capital flows (see "Public-private links for increasing capital flows to developing countries") and that of developing country representation.

More specifically, the discussion on capital flows explores new public-private mechanisms that might be considered to encourage more stable private flows to middle-income countries and aid flows to the poor countries. Three proposals are discussed: the creation of partial counter-cyclical guarantees; public incentives for encouraging socially responsible investment (SRI) in developing countries; and the International Finance Facility (IFF) put forward by the UK Treasury. Finally, there is discussion of the current proposal put forward by the Basel Committee on Banking Supervision ("Basel Committee") on modifying the regulatory capital charge of banks. As currently designed, and as suggested in the previous chapter, the Basel proposal may have an unintended negative impact on capital flows to developing countries.

The section entitled "International financial reform and development incoherence" discusses obstacles to progress on reform of the IFA from a political economy perspective. It argues that insufficient (or no) developing country representation in the Basel Committee and other international fora (as well as in the international financial institutions [IFIs]) can be identified as a major, although not the only, reason why international financial policies seem to be lacking development coherence. The penultimate section in turn discusses the challenges facing the international community for increasing developing country representation in international fora. The final section sets out conclusions and indicates areas for further research.

Capital flows to developing countries: still easily reversible?

Private capital flows can be a vital financing source to support sustainable growth and poverty reduction in developing countries. However, they declined dramatically in net terms from 1996 to 2001; this was linked to the Asian and other crises. There was a slight recovery in 2002 (United Nations [UN], 2003; see Table 3.1). During this five-year span there was a virtual drought of private flows going to developing countries, and the net transfers of flows to developing countries decreased dramatically (UN, 2004; see Table 3.2).

Table 3.1. **Net private capital flows to developing countries, 1996-2003**[1]
In USD billions

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total	157.0	208.1	96.6	38.9	66.2	18.2	17.9	51.8	64.5
Direct investment	82.0	97.2	120.5	128.0	133.0	125.6	145.3	110.0	129.9
Portfolio investment	34.2	81.5	41.6	-3.7	39.0	9.7	-41.7	-40.0	-10.4
Other net investment[2]	40.8	29.3	-65.5	-85.3	-105.8	-117.2	-85.8	-18.2	-55.0

Notes: 1. Excludes transition economies.
2. Includes commercial bank lending (short- and long-term).

Source: United Nations (2003), *World Economic and Social Survey*, UN, New York.

Table 3.2. **Net transfer of financial resources to developing countries, 1995-2003**
In USD billions

	Average 1995-1997	Average 1998-2001	2002	2003[1]
Developing countries	20.5	-123.6	-203.5	-247.5

Notes: 1. Preliminary estimate.

Source: UN (United Nations) (2004), *World Economic and Social Survey 2004*, UN, New York.

For the group of emerging market economies, net private capital flows have also declined since 1996, a trend which continued in 2002, reaching a ten-year low of USD 124 billion, according to the Institute of International Finance (see IIF, 2004).[2] In 2003, a partial recovery occurred (see Table 3.3). The recent increase in flows, projected to have continued in 2004, has been associated with the current world economic recovery and low international interest rates, and to some extent to improvements in macroeconomic fundamentals and policies in emerging countries. Although the recovery reported by the IIF has been significant, the levels of private flows to emerging market economies are still well below those observed in 1996, when they peaked at USD 325 billion.

Table 3.3. **Net private capital flows to emerging market economies, 1995-2003**
In USD billions

	1995	1996	1997	1998	1999	2000	2001	2002	2003[1]
Total	234.3	324.5	283.5	143.3	155.7	187.2	126.5	124.2	187.5
Direct investment	75.5	92.7	118.0	122.3	151.6	138.8	139.8	112.1	93.6
Portfolio investment	29.9	33.1	22.2	11.2	14.5	13.1	7.7	1.1	30.3
Bank lending	96.8	118.0	59.6	-55.0	-48.4	-0.9	-26.7	-6.2	18.9
Bond flows	32.0	80.7	83.8	64.7	37.8	36.2	5.8	17.2	44.7

Notes: 1. Estimates.

Source: IIF (2004), *Capital Flows to Emerging Market Economies*, Institute of International Finance, 15 January.

The recent increase in capital flows should be viewed with caution. First, the recovery primarily reflects cyclical factors, and is based mainly on increases in portfolio equity and bond flows, and to a lesser extent bank lending, which tend to be the more volatile components of total flows. Foreign direct investment fell in 2003, reinforcing a moderately declining trend initiated in 2001. Second, the flows are concentrated mainly in Asia, which accounts for nearly 60% of the total flows to emerging markets and for over 70% of their growth in 2003. This contrasts with the current share in total flows for Latin American and African/Middle East regions – currently at 14% and 2.6% respectively – and with the year 2001, when shares for Asia, Latin America and Africa/Middle East corresponded to 40%, 39% and 7%, respectively.

Given the role cyclical factors have played in this recent recovery, and the fact that there seem to be structural factors (such as the fact that banks have "crossed the border" and established branches and subsidiaries in developing countries, from which they lend in local currency) that may inhibit international private flows, the level of these flows may remain relatively modest (Griffith-Jones, 2003). Furthermore, a large part of recent flows may be easily reversible.

Thus, two problems identified in the past regarding capital flows are still present in the recent upward trend: *(i)* their potential reversibility, which makes host countries susceptible to financial crises; and *(ii)* their geographical concentration, implying that while some countries face surges of flows, others still receive insufficient flow levels. Moreover, a large group of developing countries (which includes the poorer ones) continues to be outside the radar of private capital flows, therefore remaining heavily dependent on aid flows for meeting their external financing needs. However, there is a consensus that to meet the MDGs, these

countries need to grow much faster, and for that they need to receive much higher levels of external finance (see UN, 2003).

Progress in international financial reforms: what are the challenges?

A number of challenges have hampered progress in improving the international financial system.

- First, there is no agreed international reform agenda for crisis prevention and management. In this context, a few developed countries have set priorities, but they are not always explicit and have varied over time. On development finance, the Monterrey Conference of March 2002 provided a full international agenda. But more action for implementation of key commitments is urgently needed, *e.g.* significantly increasing the volume of aid flows to poor countries, providing partial counter-cyclical financing to middle-income countries, using public funds as catalysts for new forms of private investment, and providing global and regional public goods.

- Second, progress thus far has been uneven and asymmetrical. The focus of reforms has been on strengthening macroeconomic policies and financial regulation in developing countries. Specifically, advances in these countries have taken place in data dissemination, monetary and fiscal policy transparency, and banking supervision. However, far less progress has been made at the international and regional levels.

- Third, though a few important steps have been taken at the international level (*e.g.* the creation of the Financial Stability Forum [FSF], and International Monetary Fund [IMF) financial facilities, namely the Supplemental Reserve Facility [SRF] and the Contingent Credit Line [CCL]), some reversals have occurred in this area. For example, the CCL, designed to provide quasi-automatic liquidity to solvent countries suffering from contagion effects, was suspended in November 2003. Also, the IMF Board has rejected advanced proposals for a structured orderly debt workout – the Sovereign Debt Restructuring Mechanism (SDRM), a proposal that had been strongly endorsed by the IMF management at the most senior level. It would seem that the main reason behind this rejection may have been the opposition by the private sector to rules they perceive would facilitate debt restructuring. Many analysts, however, believe that the main effects of a mechanism such as SDRM are to facilitate a more orderly restructuring by overcoming collective action problems. A second reason that may have contributed to the SDRM rejection is that some

emerging countries fear that the introduction of such a mechanism could further discourage private flows to them. Nevertheless, the quite recent widespread use of collective action clauses by developing countries is an important step forward.

- Finally, reforms have been characterised by insufficient developing country representation in key forums, such as the IMF, the World Bank and the Bank for International Settlements, and by their exclusion in the cases of the Financial Stability Forum and the G10 Basel Committees (Griffith-Jones and Ocampo, 2003). We argue below that this lack of or limited participation by developing countries slows progress in reform of the international financial architecture, reduces efficiency and effectiveness of IFIs to achieve their goals, and, due to the implicit democratic deficits, weakens the legitimacy of these crucial institutions.

There is thus a clear a gap between the consensus reached on the need for fundamental reforms in the international financial system, and progress made so far to ensure the achievement of global stability and increased prosperity that would help meet the MDGs. This gap can be interpreted as a lack of development coherence among OECD countries.

Public-private links for increasing capital flows to developing countries

In the current context of insufficient and still unstable capital flows to developing countries, industrialised countries may wish to explore possible steps to address these issues. This could be done through directly encouraging more private capital flows to developing countries, and significantly increasing the level of aid flows, so that developing countries can grow faster.

To encourage more, and more stable, capital flows, new public-private mechanisms might be created. In the case of private flows, we discuss proposals for partial counter-cyclical guarantees and public incentives for encouraging socially responsible investment in developing countries. In the case of official flows, we discuss the International Finance Facility proposed by the UK Treasury; if implemented, this facility could significantly increase the current level of aid flows through raising private resources in the international capital markets.

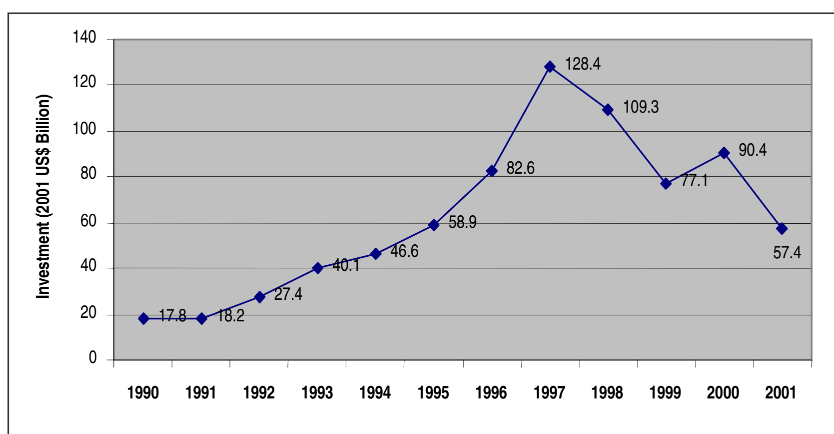
In addition, we discuss the proposed Basel Capital Accord ("Basel II"). Addressing this is crucial, as the way it is being currently proposed for implementation may have a direct impact on the issues of concern here: it may

reduce the already low levels of bank loans to developing countries and make these loans more costly and more pro-cyclical.

Guarantees for private flows, especially for investment in infrastructure

Following trends of increased private flows and encouraged by privatisation, investment in private infrastructure in developing countries surged from 1990 to 1997 (see Figure 3.1). However, this investment was particularly badly hit by recent crises (see Griffith-Jones and Fuzzo de Lima, 2005.

Figure 3.1. **Investment in private infrastructure projects in developing countries, 1990-2001**



Source: World Bank Private Participation in Infrastructure Project Database, http://ppi.worldbank.org, accessed 22 February 2005.

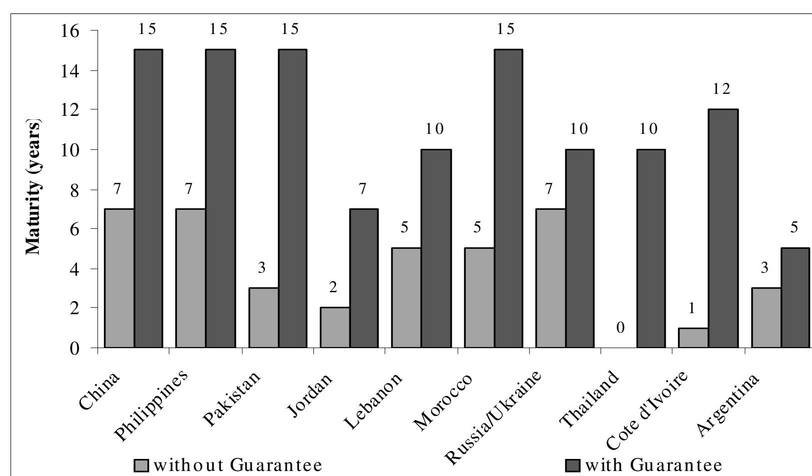
Existing public guarantee mechanisms (granted by the Multilateral Development Banks [MDBs] and Export Credit Agencies [ECAs]) play a positive role in mitigating risks of long-tern investment and loans to fund important activities, such as infrastructure investment.

Existing guarantees have positive features in that they increase flows and extend maturities of debt instruments in developing countries. According to the World Bank, this is up to 12 times what would have been without guarantees (see Figure 3.2). Nonetheless, this does not imply that the guarantees can lengthen the duration of private credits not covered by the guarantee.

Another positive feature of guarantees is their ability to reduce spreads. Loan guarantees may also affect the interest rate pertaining to the non-guaranteed private credits. For example, in Thailand the interest spread over US Treasury for infrastructure finance was calculated as 8.5% without guarantees and 2.9% with guarantees. In other countries, there is also a difference, though a less dramatic one.

In spite of all the advantages of existing loan guarantee mechanisms, they deal more with overall risks, rather than with the cyclicality of risks and loans, which has emerged as such an important feature.

Figure 3.2. **Difference in maturities in infrastructure projects in developing countries**



Source: World Bank, 2001.

It is widely accepted that international financial and banking markets tend to overestimate risk in difficult times and underestimate it in good times. As a result, private lenders are prone to boom-bust patterns that are often more determined by changing global preferences for risk aversion and/or contagion between developing countries, and less by country fundamentals. This provides a strong case for public institutions to play an explicit counter-cyclical role to help compensate for the inherent tendency of private flows to be pro-cyclical, *e.g.* in long-term trade credit.

There could be two paths for increasing the counter-cyclical role of national or international bodies. One would be for public international bodies like the Multilateral Development Banks to provide more counter-cyclical lending than already occurs, *e.g.* in infrastructure.

Another path (which if successful could provide more leverage of public resources) would be for MDBs and ECAs to introduce an explicit counter-cyclical element in all the risk evaluations they conduct for issuing guarantees to lend to developing countries. This would require that MDBs and ECAs conduct risk assessments with a more long-term perspective than is typically held by commercial banks; this would imply that when banks or other lenders lowered their exposure to a country, multilateral and regional development banks or ECAs would increase their level of guarantees (if they considered that the country's long-term fundamentals were basically sound). When matters were seen by private banks to improve, and their willingness to lend increased, MDBs or ECAs could decrease their exposure, for example by selling such guarantees in the secondary market. This would avoid greater counter-cyclicality of guarantees, resulting in an increase in the long-term level of guarantees.

To the extent that MDBs and ECAs increasingly use risk-assessment models (as is the case of the UK Export Credit Guarantee Department), taking a more long-term view would require the use of more long-term models than those used by private lenders. These would be models that are presumably better at "seeing through the cycle" as they would use more measures of risk focused on long-term fundamentals that are less affected by short-term variations than market-sensitive measures typically are.

Alternatively there could be special standalone guarantee mechanisms for long-term trade credit, for example within multilateral or regional development banks, or even bilaterally, that had a strong explicit counter-cyclical element. This could be activated in periods of pre-crises, during crises or for a country facing a sharp decline and/or dramatic increase in cost of capital inflows as it or other developing countries emerge from crises. Its aim would be to try to catalyse long-term trade credit, especially linked to infrastructure, broadly defined.

Indeed, once the need for and positive role that explicitly counter-cyclical guarantees could play to catalyse private long-term credit and investment to developing countries are accepted, it will be important to define where such guarantees should be placed institutionally. ECAs have traditionally played an important role in providing such guarantees, but the role of several developed countries' ECAs in granting guarantees for lending and investing in developing countries is declining. If this trend continues, it seems imperative to both: *(i)* expand; and *(ii)* make explicitly counter-cyclical, guarantees in multilateral and regional development banks, either by introducing counter-cyclicality as a general criterion for all guarantees or by creating a standalone facility for this purpose.

To ensure that there is an effective expansion of the level of guarantees issued by multilateral and regional development banks, existing guarantee mechanisms may need to be improved or enhanced and/or new mechanisms may need to be created. In addition, existing problems may need to be overcome: excessive restrictiveness of criteria for granting guarantees; approval processes of guarantees that may be too cumbersome; excessive costs of such guarantees. Furthermore, mechanisms for increased leverage of development banks' resources in providing guarantees might be further explored and implemented, *e.g.* guarantees could be provided only for later maturities of long-term projects.

Another possibility is to develop further liquidity facilities, where guarantees can only be called after a big devaluation (up to a pre-established level of devaluation). In this case, the guarantee would be provided for a fixed period (*e.g.* two years), after which the loan would have to be fully settled (for more details, see Griffith-Jones and Fuzzo de Lima, 2005. If studies are not carried out and – above all – action is not taken to ensure that multilateral and regional development banks increase the level of their guarantees, the valuable introduction of explicit counter-cyclical elements in such guarantees would become far less meaningful. This would then imply the need for standalone counter-cyclical guarantees, either multilaterally or regionally, or even in individual developed countries.

If properly designed and implemented, counter-cyclical guarantees could provide an important policy instrument to help deal with a genuine market failure – the boom-bust pattern of private lending; the desired policy outcome would be to help smooth private lending.

SRI investment in developing countries: a potential source of long-term flows?

Socially responsible investment assets have grown dramatically in recent years, reaching USD 2.7 trillion in 2001. In the United States, they grew from just USD 1.0 trillion to over USD 2.0 trillion between 1997 and 2003. In the United Kingdom, SRI growth has been even more dramatic – with asset values quadrupling from just about GBP 50 billion in 1999 to over GBP 200 billion in 2001 (Sparkes, 2002).

Changes in the UK legislation on pension funds have been signalled as a key factor in this increase. In 2000, the UK government modified the 1995 Pensions Act to require that pension funds report to what extent their investment decisions take into consideration social and environmental issues (Coles and Green, 2002). This seems to have propelled UK institutional investors into significantly increasing their SRI investments. As a consequence, today over 80% of total UK SRI assets are held by institutional investors.

However, the strong growth SRI has exhibited in the recent past is limited mainly to the acquisition of developed country assets. Of the USD 2.7 trillion of total SRI assets in 2001, only 0.1% was emerging market (EM) assets (IFC, 2003). This is much lower than the share of emerging market assets held by mainstream investors, of around 2-3%. There is therefore potential for SRI growth in emerging markets.

An acquisition of EM assets can be justified both on moral and economic grounds. On the moral side, it is well demonstrated that developing countries face an enormous external financing gap, which, if not filled, will result in slow growth and poverty-reduction patterns. SRI investors, especially if the flows are long term and fairly stable, could help developing countries grow faster, create jobs and reduce poverty by investing in these countries. This would lead to overall prosperity in developing countries and would therefore be coherent with SRI global sustainability concerns. On the economic side, investing in emerging markets can be justified by the fact that historically returns on EM bonds, equities and bank loans have been higher than developed country returns on each of these assets (Gottschalk, 2004). Furthermore, investing in EM assets may bring clear portfolio diversification benefits, in terms of risk reduction for a given level of return, to the extent the correlation between developed country returns and developing country returns is lower than within developed countries. This hypothesis has been empirically confirmed through a battery of statistical tests using a wide range of data (see below).

Despite these potential benefits, the SRI investor community points to a number of barriers for acquiring EM assets in a major way. Most of these barriers are related to pure lack of knowledge about the opportunities EMs can offer and to informational gaps on environmental and social standards in EMs. The latter can only be overcome if demand for EM assets increases to justify the establishment of research organisations that can provide systematic information on these standards (IFC, 2003).

The official sector in industrialised countries could provide incentives to encourage the creation of an SRI investor community based in their countries to invest in EM assets. For example, they could follow the UK example by modifying pension funds legislation to include a requirement for institutional investors to report on their policies regarding investing in EMs on a regular basis. Indeed, UK legislation might enhance its development coherence level if it were modified specifically to highlight developmental concerns in the required reporting by pension funds. One possibility would be to set a minimum developing countries' EM asset holding target to be reached within a specific timeframe.

Moreover, the official sector could facilitate the establishment by the SRI industry of a set of principles to guide their investment decisions towards EMs, in the same way the International Finance Corporation (IFC, which is part of the World Bank Group) has done with major internationally active banks in establishing the Equator Principles on social and environmental issues. Of course, it would be important that these principles be broad enough to include development elements. The MDGs could serve as a basis for the establishment of these principles. They could include supporting economic growth and poverty reduction, by generating jobs and paying minimum (or higher) wages (based on the country wage level) – and at the micro level, encouraging companies to engage in the provision of health facilities and primary educational programmes, as well as training for the working force (Gottschalk, 2004; Williamson, Griffith-Jones and Gottschalk, 2003).

Providing legislative and other incentives for the SRI investor community to invest in developing countries would be developmentally coherent due to their enormous potential as a source of long-term flows to developing countries. Moreover, it would be coherent with SRI needs to match their liability structure with long-term investment in assets with high returns, which developing countries can provide due to their abundant and relatively young labour force and therefore long-term growth potential. More broadly, SRI investment in developing countries would be coherent with their global sustainability concerns, as global stability and prosperity can only be achieved if developing countries eradicate poverty and experience economic growth on a sustainable basis.

The development coherence sought in this case involves private sector actors (investors, NGOs) in particular, as well as (though to a lesser extent) public actors. New modalities of interaction need to be found, including new incentives. Further research may be required to make it successful.

Could the IFF double aid flows by 2015?

Having considered possible alternatives for encouraging more long-term private flows to developing countries, and for this purpose explored possible public-private links, we turn to the proposal by the UK Treasury to create an International Finance Facility (IFF), aimed at doubling the current levels of aid flows to developing countries until 2015.

The reason for discussing this facility is that, even if private capital flows to developing countries increase substantially, it is still very likely that a large number of developing countries (particularly the poorer ones) will continue to lack access to private flows for a long period. There is thus an urgent need to increase substantially

the current levels of aid flows to these countries to achieve sustainable growth and eradicate poverty.

To double the current levels of aid flows, the IFF proposes to frontload aid flows by raising private resources in the international financial markets through issuing bonds. The operation would be secured by donors' commitments to multi-year streams of annual payments to the IFF (see HM Treasury and DFID, 2003).

The disbursements of resources raised would be concentrated in the years leading up to 2015, while the streams of donors' income to the IFF would be distributed over a 30-year period. Not all donors would have to agree to the facility for it to be implemented. And those donors agreeing to the facility would be able to allocate the resources raised linked to their contributions using the existing channels of aid disbursement. Moreover, they would be able to decide to which countries they would allocate such resources.

The levels of income commitment would be decided by each donor and would be subject to "high-level" financing conditions; these, if not met by the recipient countries, would permit donors to suspend their payments. However, to reduce bondholders' uncertainty (thereby ensuring that the bonds issued by the facility achieve the highest possible rating), a number of rules would be imposed:

1. The conditions for the recipient country would be very general, *e.g.* not ever subject to UN sanctions.
2. No country would be permitted to receive more than 5% of total disbursements, thereby diluting the possible impact of one country breaching the conditions on donors' income payments.
3. The IFF would be limited to raising capital to the equivalent of no more than 85% of the net-present-value of its future income.

At the same time, donors would have to follow a set of principles in their disbursement programmes. These would probably include the following: the resources would have to be untied, used for poverty alleviation, provided on a multi-year basis, disbursed mainly in the form of grants, and concentrated in low-income countries (HM Treasury and DFID, 2003).

The proposed facility and the conditions attached to it seem fully consistent with the international consensus reached at the Monterrey Conference on the need to increase aid flows substantially in the years leading up to 2015 and to use these flows to help the poorer countries achieve the international development targets. It

seems important to emphasise that the IFF should be seen as a complement, and not a substitute, for directly increasing aid.

The proposed facility is thus a possible further mechanism to channel private capital towards financing development. In this sense, it shares the same objectives as the partial counter-cyclical guarantee and SRI investment proposals, albeit it would differ from them by necessitating a larger amount of public resources to secure the whole operation. Key features include its flexibility in the levels of resources donors would have to commit to it; in how resources can be disbursed; and in not depending on a high number of adherents for it to be launched (though it has the support of a number of developing countries). Among the industrialised countries, a few large ones, *e.g.* France and Germany, clearly supported the initiative during the G7 Finance Ministers' Meeting, held recently in the United Kingdom.

The Basel proposal on regulatory capital charges: a look at its unintended negative consequences

As noted earlier, it is important to encourage more private capital flows to developing countries. But it is equally important to avoid an international regulatory framework that may have an unintended negative impact on these flows. Basel II, the current proposal to modify banks' regulatory capital, may have such unintended consequences – like inappropriately discouraging international bank lending and making it more costly, as well as making such lending more pro-cyclical. These consequences would *not* be coherent with the aims of the developed G10 governments, *i.e.* to support private international flows so as to help achieve higher growth in developing countries, and thus contribute to achieving the MDGs.

It is true that that the third consultative package of Basel II has positive features: the removal of the OECD/non-OECD distinction, and the reduction of the bias towards short-term lending to developing countries (Griffith-Jones, 2003). However, problematic issues emerge, particularly from a development perspective, with the internal ratings-based (IRB) approach.

The main issue is that it overestimates the risk of lending to developing countries, as it does not take into consideration the considerable benefits of international portfolio diversification (see above). Given that some banks already take account of diversification benefits in their risk management practices, implementing the current proposals would imply a step backwards.

This overestimation of the risk of lending to developing countries implies a significant increase in regulatory capital requirements for lending to developing

countries, which is likely to result in both less lending and an increase in the costs of the remaining lending.

It is noteworthy that several of the major international banks have stressed how negative it is that the Basel Capital Accord does not include the benefits of international diversification. Stanley Fischer, Vice Chairman of Citigroup argues that:

> Large international banks that are active in emerging market economies would probably consider Basel II well worth the price of admission if the new Accord took account of the benefits of global diversification in increasing these banks' risk capacity. But unfortunately, it does not – and this is a key point. Specifically, in its current form, Basel II requires capital requirements in each country to be calculated on a standalone basis. This could significantly increase the capital requirements for operating in these markets.
>
> ... In not taking into account the risk mitigation effects of international diversification, Basel II in its current form runs the risk of materially reducing the incentive for larger internationally active banks to maintain and expand their operations in emerging market economies. Given the economic and other benefits of such operations, not just for the host economies and for the international financial system more generally, this must be considered a significant shortcoming. (Fischer, 2002)

In a more general sense, a variety of financial institutions, including representative industry bodies such as the IIF (which represents all major international banks) and the New York Clearing House Association (that represents several of the major banks), have argued strongly for the incorporation of the benefits of international diversification into the Accord. The Clearing House commented as follows in its submission to the Basel Committee in August of 2003:

> Under Basel CP3, the benefits of diversification of business lines, asset classes, geographical regions and risk types is not adequately recognized in assessing capital requirements. This is in contrast to modern economic theory, industry practice and empirical evidence. Diversification mitigates the possibility and extent of loss by allowing holding companies to rely on earnings from one area when another area slows or experiences losses and to benefit from diversification of risk. Diversification also allows strength in market or credit performance in some areas to offset weaknesses or problems in others without necessarily drawing on capital. The regulatory capital requirements should reflect the benefits of diversification.

In Griffith-Jones, Spratt and Segoviano (2002), empirical work was presented confirming that the degree of correlation between the real and financial sectors of developed economies is greater than that which exists between developed and developing economies. This hypothesis of differential correlations was tested, first with specific regard to international bank lending and profitability and, secondly, in a more general but supportive sense. All of the results offered significant support for the validity of this position (see chapter Annex 3.A, Table 3.A.1). The fact that every statistical test performed, regardless of variable, time-period or frequency, has pointed in the same direction – and all are clearly statistically significant on a variety of tests – offers robust and unequivocal support for the benefits of diversification.

As a consequence, an internationally diversified loan portfolio, with a range of developed and developing country borrowers, would have a lower level of risk – in terms of the overall portfolio – than one which focused primarily on developed country lending. In order to test this hypothesis in the specific context of a bank's loan portfolio, a simulation exercise in Griffith-Jones, Spratt and Segoviano (2002) was undertaken to assess the potential unexpected loss resulting from a portfolio diversified within developed countries, and one diversified across developed and developing regions.

The unexpected losses simulated for the portfolio focused on developed country borrowers were, on average, almost 23% higher than for the portfolio diversified across developed and developing countries. This offers more direct evidence that the benefits of international diversification produce a more efficient risk/return trade-off for banks at the portfolio level. In order to reflect accurately the actual risks that banks may face, Basel II should take account of this effect.

Further evidence using real data has been provided by the major Spanish bank, BBVA (*Banco Bilbao Vizcaya Argentaria*), in its paper, "A Practical Proposal for Improving Diversification Treatment in Basel II" (BBVA, 2004a). This paper defines a "correction factor" which measures the error made when using a single factor model – such as that envisaged in Basel II – when in fact there are two (or three) factors affecting diversification of the portfolio. These factors could be geographical areas (emerging *versus* non-emerging economies), industrial activities or a combination. The correction factor is defined as the ratio between the capital calculated with the two (or three factor model) and the capital obtained with the single factor model. The authors calculated the following values for the correction factor.

The diversification index measures how diversified the factors considered in the portfolio are. A diversification index of 35% indicates maximum diversification and 100% indicates maximum concentration. In a situation of no diversification, the

discrepancy between the one-factor model (to be used in the Basel II IRB framework, which does not take account of the benefits of diversification), and the two- and three-factor models is zero. As diversification increases, so does the discrepancy between the Basel II one-factor model and the more sophisticated two- and three-factor models: as diversification increases, the Basel II one-factor model grows increasingly inaccurate in its overestimation of the capital required.

The maximum capital saving in the BBVA empirical work (2004b) (for both the two- and three-factor models) ranges from 16% to 21% (see the chapter Annex 3.A, Table 3.A.2). These figures coincide with the simulated calculations reported above, suggesting that something beyond a particular case is being captured here. In short, if a one risk factor model were used as proposed under the Accord, it would require capital requirements to be higher than the two- and three-factor models by between 16% and 21%, which can be seen as a proxy for the failure to take account of international diversification.

Given this evidence, as well as the widespread acceptance of the risk-reducing benefits of international diversification, it is strange that these benefits have not been incorporated into the Basel II proposals. This is particularly so given that the Basel Committee itself does not deny that these benefits exist. The new Chairman of the Basel Committee, Jaime Caruana, makes this explicit:

> Portfolio theory suggests that an obvious step to further enhance the risk-sensitivity of the capital framework would be to incorporate calculations of diversification benefits into the framework. (Caruana, 2003)

The intention of moving Basel to full credit-risk models is highly welcome. However, it is important that in a transition phase – whilst they are being developed – benefits of diversification are already incorporated in simpler ways. If this is not done, international banks may be inappropriately discouraged in the short term from lending to developing countries, a trend which may then take some time to reverse due to factors such as the need of re-hiring expertise for such tasks. Such a reduction of international bank lending could have negative impacts on output and poverty reduction.

As demonstrated above, the failure of the proposals to date to take account of the benefits of international diversification suggests that, in this instance at least, risk has not been accurately measured. The fact that the proposals under Basel II will not allow these diversification benefits to be taken into account suggests that the regulatory capital associated with lending to developing countries will be *higher* than that which the banks would – and currently are – choosing to put aside on the

basis of their own models. This will inappropriately reduce lending to developing economies and increase its cost.

The specific manner in which the Basel Committee – and later the European Commission for the Capital Adequacy Directive (CAD3) – might want to incorporate these findings is best left to them. However, BBVA has proposed a simple practical adjustment mechanism that enables the introduction of the benefits of international diversification into the current proposal. The mechanism proposed consists of using the previously mentioned correction coefficient, so that regulatory capital is defined from the one-factor model currently proposed multiplied by this coefficient:

Capital adjusted for diversification = *Capital defined by the one factor model* x *Correction coefficient*

That is, a diversified bank would multiply its total regulatory capital by a coefficient to correct for diversification, with the coefficient being proportional to the degree of diversification. Adoption of such a correcting factor (at least as a transitional measure until full credit risk models are sufficiently robust to be used directly) would *(i)* produce a more accurate measure of risk than under the current proposals; and *(ii)* prevent the overestimation of risk for international borrowers – particularly those in emerging and developing economies, that could be damaging to their economies.

A second problem is that Basel II is likely to accentuate the pro-cyclicality of bank lending, as banks would have to increase their capital requirements in bad times. This would harm developing countries, especially those most vulnerable to sharp fluctuations in bank lending (Griffith-Jones, 2003).

Lack of developing country representation in the Basel Committee may be an important reason why the proposed rules have been designed to benefit more internationally active banks based in developed countries and yield less benefit to developing countries.

Proposals to improve Basel II as currently designed might therefore include:

1. The incorporation of international diversification benefits in the internal ratings-based approach, so that risk is measured accurately, along the lines suggested above. To this end, a similar approach could be pursued to that recently adopted, of incorporating in the risk calculation the diversification benefits of lending to small and medium-sized enterprises (SMEs).

2. Mitigating the increased pro-cyclicality that would result from the adoption of the IRB approach with counter-cyclical measures, which may include making forward-looking provisions and stress testing, mandatory.
3. A change in the representation of the Basel Committee to include representatives of developing countries.

International financial reform and the political economy of development incoherence

The discussion above suggests that there is a serious disjuncture between, on the one hand, the needs of developing countries for stable funds to finance their future development and, on the other hand, the policies and practices that characterise the international financial architecture. Little progress has been made in terms of constructing an international financial architecture that encourages more private capital flows to developing countries, significantly increases the level of development assistance to developing countries, and reduces the prospects for international financial instability. In short, there is considerable incoherence between the international community's desire to reduce poverty and promote sustainable development in developing countries (as expressed, for instance, in the MDGs) and the nature of international financial arrangements.

Why have we not seen the emergence of an international financial architecture that is more conducive to development in developing countries? There have been two main reasons for this.

First, developing countries have been inadequately represented in key international forums and institutions where reform of the international financial system has been discussed and enacted. Developing countries account for approximately 85% of the world's population and a significant proportion of global GDP, but they control only small proportions of votes in key international financial institutions such as the World Bank and the IMF. In the IMF, for instance, they control just over 30% of total votes. The voting power of individual members at the IMF largely reflects the size of their respective quotas. Furthermore, each country member has 250 basic votes but the ratio of basic votes to total votes has fallen over the years as quotas have grown: whereas the basic votes of the 45 founding members of the IMF accounted for 11% of their total voting power in 1944, by the 1990s basic votes accounted for less than 3% of members' total voting power, even though the number of member countries tripled during this period.

At the same time, developing countries have been completely excluded from bodies such as the Financial Stability Forum and the G10 Basel Committee, both of which have played important roles in promoting reform of the international financial system in recent years. Developing countries *have* been included in the Group of 20, a body set up to facilitate dialogue on international financial reform between developed countries and developing and transition countries whose size or strategic significance gives them a particularly crucial role in the global economy. But it has been primarily a consultative rather than decision-making body and has only addressed a relatively narrow range of financial sector issues (Griffith-Jones, 2002; Griffith-Jones and Ocampo, 2003; Claessens, Underhill and Zhang, 2003).

With developing countries lacking adequate representation in these forums, their interests have often been subordinated to those of governments and firms in the developed countries. This is evidenced in the case of Basel II. The Basel Committee does not have any developing country members. Its membership consists of the G10 plus Switzerland. The committee meets every two months with representatives of 13 countries that are outside the G10, including China and Russia. But this consultative group has no decision-making authority; it merely reviews developments and comments on the committee's work. Whilst this gives these countries a chance to provide some input to the Committee, it does not give them a seat at the decision-making table (Griffith-Jones *et al.,* 2004).

Several of the major international banks strongly support introducing the benefits of international diversification into Basel II, which will lower the cost of lending to developing countries. Indeed, some banks, such as the large Spanish banks, support this point very actively. The IIF, a private think tank in Washington, D.C. representing around 350 member banks worldwide, also supports this point, as do the major developing countries, and several leading academics. It is therefore surprising and difficult to explain why, at the time of writing, this modification had not been introduced. One reason may be bureaucratic inertia; another is that there are several outstanding issues; and a third is that large banks focus on pushing those policies which they perceive (possibly wrongly) may have greater impact on their profits. The fact that the case for international diversification does not have a champion inside the Basel Committee (as no developing country is represented) is crucial.[3] It may lead to an outcome which is technically clearly sub-optimal (from the main aim of Basel II, to more accurately measure risk), economically incorrect and incoherent with sustaining development.

The Basel II proposals overall reflect the interests of large private banks from developed countries. By introducing a more market-based supervisory approach for large banks, and in particular by allowing these banks to use the so-called "IRB" approach to calculate regulatory capital based on their own credit-risk models, this

will significantly reduce their levels of regulatory capital for lending to credit-worthy companies, in turn lowering their costs and boosting their competitiveness (Claessens, Underhill and Zhang, 2003; Whalen, 2004). At the same time, the proposed Basel II clearly reflects the weak position of developing countries in global financial governance, particularly insofar as it may increase the possibility of reduced lending to these countries and greater pro-cyclicality in lending. In serving more the interests of large private financial institutions and large companies, the Basel Committee is probably unintentionally at risk of sacrificing the interests of developing countries.

One hope for developing countries is that emerging divisions over Basel II within developed countries will require it to be reformulated. Basel II has been criticised by banking regulators in the United States that have links to small US banks, such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, both of which are concerned about its effects on the competitive position of small banks. Elements within the US Congress, particularly key members of House of Representatives Financial Services Committee, have also expressed concern about the effect of the proposal on small banks (Whalen, 2004). Indeed, the IRB approach will only be applied to the largest US banks. European venture capital firms have also criticised the proposal on the grounds that the new rules could reduce banks' ability to invest in private equity (Gimbel, 2004). If Basel II is reformulated again, however, the influence of developing countries in the reformulation process is likely to be weak. Excluded from the Basel Committee, developing countries will be forced to rely on the influence of countries such as Spain which, because its banks are highly exposed to developing country borrowers, might have its own reasons for wanting to change the proposal, or countries whose governments are so committed to development and meeting the MDGs that they would support a modification that makes Basel II both technically more precise and more supportive of growth in developing countries.

The second reason why we have not seen the emergence of an international financial architecture that is more development-friendly is that there are serious collective action problems among developed countries in relation to the provision of greater aid to developing countries. Developed countries have an interest in sustained economic growth and reduced poverty in developing countries. Sustained economic growth in developing countries would create greater opportunities for trade and investment between the two sets of countries and, by doing so, lead to higher income levels and living standards in developed (as well as developing) countries. At the same time, insofar as there is a link between poverty levels in developing countries and threats to the security of developed countries, reduced poverty would improve the security situation for developed countries. But there are deep divisions among developed countries about how the financial cost of achieving

these objectives should be shared. When some governments increasingly prefer to deal with developing countries on a bilateral or unilateral basis rather than through multilateral institutions, thus further reducing the scope for collective action by developed countries in relation to aid provision.

These dynamics can be seen at work, for instance, in the case of the UK's IFF proposal. This proposal has won backing from a number of developing countries including Brazil, China and India (Wray, 2003). But among the large developed countries, it has thus far failed to win support from Japan and the United States. Japan has expressed strong opposition to the proposal, reportedly because of concerns about its budgetary position, which is rather precarious. The United States has also expressed opposition to the IFF but for different reasons. The US government has recently committed itself to substantially increasing its aid budget, but has preferred to channel this money through its Millennium Challenge Account (MCA), a fund that would provide aid to countries that are "ruling justly, investing in their people, and establishing economic freedom" (as quoted in Radelet, 2003). Also, the Netherlands and the Scandinavian countries have been lukewarm towards the proposal, apparently because they are concerned that it would mean increasing their aid budgets beyond their already high levels, relative to other developed countries (these countries are among the few countries that currently exceed the UN's target for aid as a percentage of gross national income). Furthermore, these countries argue that an increase of aid flows, by countries not meeting the 0.7 target, could be a simpler way of increasing aid flows.

Challenges for increasing the voice of developing countries

The case for increasing the voice of developing countries in the governance of international financial institutions is compelling. Current arrangements wherein developing countries are increasingly under-represented is problematic for several reasons. First, inappropriate representation arrangements lead to a *decline in the efficiency* of these organisations, as decisions taken do not adequately reflect the needs and issues from the perspectives of the majority of the countries and peoples affected by them. A clear example is that of the Basel Capital Accord, where developing countries are not represented on the Basel Committee. Rustomjee (2003) provides similar examples of inefficient outcomes linked to insufficient developing country participation in decision making in the IMF (for example in the design of HIPC [heavily indebted poor countries] Initiative and poverty-reduction strategy papers [PRSPs]).

Second, insufficient representation of developing countries is increasingly perceived in the literature as leading to a *democratic deficit* in those institutions.

Given that democratic governance has rightly emerged as such an important value in the last decade, and that developed country governments rightly encourage democracy in developing countries, it is crucial that international finance governance also be democratic. This will be positive for the international financial institutions themselves, as it will clearly strengthen their legitimacy, which has been challenged in recent years. More democratic, legitimate financial institutions will strengthen international financial governance and institutions that are needed in a globalised world.

Third, increasing the share of developing countries in IFI governance is necessary to help *modernise* them, so they reflect the increased importance of these countries in the global economy, as well as the increased role of the IFIs in these countries. Thus, IFI governance has to better reflect today's new realities, rather than those of 60 years ago. It is encouraging that the international community has increasingly focussed on this important issue. In Monterrey, all governments committed to increasing the voice of developing and transition countries in IFIs.

There is widespread recognition in the literature (see for example, Buira, 2003 and Kelkar, Yadav and Chaudhry, 2004) that necessary changes would include:

1. An increase in the share of basic votes is desirable to allow meaningful representation for smaller economies, as was established at Bretton Woods. Once increased, the share of basic votes should be maintained in future quota increases, to prevent similar future erosion. With the nearly 37 fold increase in quotas over the past 60 years, the share of basic votes in the IMF fell sharply, while IMF membership quadrupled. This has shifted the balance in favour of large economies. The need to raise the share of basic votes is a proposal that has obtained increased support, including among some developed countries.
2. The quota formula needs amending to reflect appropriately the rapid growth of some developing economies, as the current quota structure does not properly reflect the scale of countries' economies. As Table 3.4 and Buira (2003) point out, large countries like Brazil, China, Korea and Mexico have a share of quotas that are far below their share of gross domestic product (GDP), while a few small European countries have quotas for larger than their share of GDP. This is true for both GDP measured at market exchange rates and at purchasing power parity (PPP), particularly the latter.[4]
3. There is a need in the IMF and World Bank Boards, to add at least one seat for African countries. This would reduce the enormous burden and growth of workload in the two African constituencies (that represent 45 countries

jointly) and would allow African Executive Directors to play a more active and effective role in broader policy discussions. This change would imply a very marginal increase in the size of the two boards or a very small reduction of European representation. Procedurally, it would be relatively easy to implement as it does not require a change in the Articles of Agreement.

Table 3.4. **IMF quotas and GDPs for selected countries**

Country	Quota as of 13 December 2002: Billions of special drawing rights	Quota as of 13 December 2002: As a proportion of total quotas	Share of world aggregate GDP in PPP, 2002	GDP, 2002 USD billions converted at market exchange rates
Canada	6 369	2.99	2.01	728
China	6 369	2.99	12.67	1 237
Russia	5 945	2.79	2.68	346
Netherlands	5 162	2.43	0.88	449
Belgium	4 607	2.16	0.59	247
Switzerland	3 458	1.63	0.45	268
Brazil	3 036	1.43	2.63	448
Mexico	2 586	1.22	1.90	642
Denmark	1 643	0.77	0.33	172
Korea	1 634	0.77	1.78	462

Source: Buira (2003), based on IMF World Economic Outlook Database.

The way forward?

To make such changes acceptable to industrialised countries and to maintain credibility of the IFIs in international capital markets, it would seem that a compromise solution could be sought. This would attempt to achieve the changes suggested above, in a way that would increase the overall voting share of developing countries fairly significantly, as well as guarantee that – for a significant period, *e.g.* the next ten years – the voting share of developing countries in the IMF and World Bank Boards would remain at below 50%. Also, to make it politically feasible, it should maintain the veto power of the United States and the European Union. This would be a win-win situation for all parties, in that developing countries would see their share increased fairly significantly, but creditors would maintain their majority. The AAA status of the World Bank would be clearly assured (indeed, the regional banks maintain AAA status even with 50% developing countries share of votes on their boards).

It is important to note that Kelkar, Yadav and Chaudhry (2004) have made a proposal concerning quota and voting power of the board that would meet the above criteria precisely. A similar proposal could be applied for the World Bank. In the Kelkar, Yadav and Chaudhry (2004) proposal, voting power would be determined by weighted averages for PPP GDP (88.7%) and basic votes at the historic ratio (11.3%). As illustrated in Table 3.5, this would mean that the voting share of developing countries would go up in the IMF from 30.5% to 42%, thus clearly increasing their voice, while developed countries would reduce their voting share from 62% to 51%, but maintain their majority. Both the United States and the European Union would retain their veto power. Asian developing countries would also have veto power, if united.

Table 3.5. **Present and proposed quota and voting power**

Country category[1]	**GDP PPP 1997-99 Average**	**Present quota share**	**Proposed quota share on basis of GDP PPP**	**Present voting share**	**Proposed voting share on basis of GDP PPP (87.7%) and basic votes (11.3%)**
	Special drawing rights in billions	%	%	%	%[2]
Advanced economies	16 303	62.763	55.492	61.768	50.950
Major advanced economies	13 375	46.030	45.523	45.146	40.811
Other advanced economies	2 929	16.732	9.969	16,622	10.139
United States	6 315	17.383	21.494	17.030	19.127
Japan	2 282	6.229	7.767	6.110	6.951
European Union	5 900	30.106	20.083	29.647	18.740
Developing countries	11 320	29.697	38.530	30.529	42.019
Africa	1 086	5.493	3.695	5.962	6.427
Of which Sub Saharan Africa	873	4.496	2.970	4.952	5.599
Asia	6 181	9.120	21.038	9.250	20.390
Western Hemisphere	2 504	7.456	8.523	7.666	9.536

Notes: 1. Country categories are based upon IMF World Economic Outlook.
2. Does not total 100%, as transition economies are not included.

Source: Kelkar, V., V. Yadav and P. Chaudhry (2004), "Reforming the Governance of the International Monetary Fund", *World Economy*, 27(5), May, pp. 727-743.

Such a reform, or another variant, of voting power in the IMF and World Bank would allow both developing and developed countries to feel that they have achieved their main aims: developing countries, by seeing their voice enhanced, and developed countries, by maintaining their majority as a group. The ultimate gainers would be the Bretton Woods institutions that would emerge stronger, more efficient, more democratic and more legitimate, while maintaining credibility with the markets. Greater coherence with development aims would be achieved.

There are of course many other possible elements that could be included in such a package (such as the method of election of the heads of these institutions, the possibility of different majorities for different issues, and others).

Proposals such as the above might provide a useful basis for constructive negotiations in the Development Committee[5] and other appropriate fora. It would be valuable if developing countries could unite in support of such a formula and if developed countries sympathetic to a genuinely increased voice for developing countries would also support it.

It is important to stress that there are other international financial institutions where developing countries either have no representation at all on the board, even though they are members (*e.g.* the Bank for International Settlements) or are not members at all (the Financial Stability Forum, and the Basel Committee, as discussed earlier).

This is clearly negative in terms of the efficiency, democracy and legitimacy of these important bodies. It is particularly problematic that developing countries have no participation in important standard-setting bodies like the Basel Committee. The fact that, as presently proposed, the new Basel II may inappropriately increase the cost and reduce the level of international bank lending to developing countries, while ignoring the clear benefits of international diversification that such lending provides, again shows how inappropriate (or in this case, no) representation of developing countries can lead to technically incorrect and economically damaging outcomes.

Given that the Basel II is a global standard that is likely to have a very large impact on emerging economies, and that emerging markets are critical to the global economy, the composition of the Basel Committee needs to be changed. A more sensible composition would reflect global GDP. The ten largest economies would bring in Brazil, China, India and either Mexico or Russia to the Basel Committee to join France, Germany, Italy, Japan, United Kingdom and the United States. The new countries are critical to the global economy and to cross-border bank lending.

Another possibility is that current membership could remain and Brazil, China and India could be added. Alternatively, one or two representatives per developing country region (Asia, Latin America and Africa) could be added for a four-year period. There could then be a rotation to ensure that different countries are represented (from each of the three regions). The principle would be similar to the one under which the Executive Boards of the IMF and World Bank operate. Particularly, but not only, if the latter formula is adopted, developing country representatives could be supported by a small permanent technical secretariat that would contribute both expertise and continuity. In fact, the lack of such a secretariat at present is an important institutional gap.

We suggest that the Basel Committee start meeting with a representative group from emerging countries (such as its own consultative group or members of the G24 that represent developing countries at the IMF) to establish a process whereby emerging countries can quickly become full members of the Basel Committee. A Basel Committee with appropriate representation from the world economy would not just result in a fairer system, but also in a more stable financial system with welfare-enhancing effects for all and greater coherence with development objectives.

Conclusions and further research

Progress with regard to constructing an effective international financial architecture has been limited and uneven. This has meant that the existing international financial system is not supportive of, and coherent with, growth and development. One very important reason for lack of progress on the reform of the international financial system and for inefficient outcomes is the insufficient voice of developing countries in international financial governance.

An important policy area where there has been insufficient discussion, and especially action, is that of ensuring more and more stable capital flows to different categories of developing economies. This is essential to ensure that capital flows support, and do not undermine, development. It is also important that developing countries receive and perceive net benefits from their increased financial integration into the world economy.

More specifically, issues such as expanding guarantees and making them more counter-cyclical, so as to catalyse more and more stable flows, seem very important. Also, the transformation of SRI into a vehicle that helps channel private flows supportive of development is a weighty challenge. Further research in these two areas, which may lead to the design of specific mechanisms and incentives, would

seem essential, to help ensure the coherence between capital flows and development. Similarly, the new Basel II needs to be designed in ways that does not inappropriately discourage lending to developing countries, nor increase its pro-cyclicality.

As discussed, increasing the voice of developing countries is critical to increasing the efficiency and democratic legitimacy of financial governance – to create a system that accurately reflects today's economic and political realities. Research seems urgently needed on evaluating and prioritising a range of options in areas such as the composition of the Boards of the Bretton Woods institutions and the Bank for International Settlements, as well as the composition of the standard-setting committees, such as the Basel Committee. The potential impact on the trade-offs between efficiency, equity and development coherence could be evaluated by studying other international institutions, both financial (such as the International Organization of Securities Commissions) or in other areas (World Trade Organization or the General Environment Fund), where developing countries have a larger participation in decision making. Lessons could be drawn. The experience of protecting rights of minority shareholders in private companies' corporate governance and possible lessons for international financial governance could also be very relevant. Finally, a study of the political economy factors that determine obstacles to desirable changes that would achieve development coherence could also be pertinent.

Perhaps the following questions could be addressed in the future:

- What would be the best mechanisms for catalysing more and more stable private flows to developing countries, and how could initiatives on this be taken forward?
- How can the proposed Basel Capital Accord be modified to make it more coherent with development aims, and how best can obstacles to such changes be overcome in the time available before its approval?
- What are constructive and feasible proposals to increase the voice of developing countries in international financial governance in the near term?

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NOTES

1. Stephany Griffith-Jones, Ricardo Gottschalk and Andrew Rosser are from the Institute of Development Studies, University of Sussex, UK. It should be noted that the opinions expressed and arguments employed in this chapter are the sole responsibility of the authors and do not necessarily reflect those of the OECD or of the governments of its member countries.
2. The figures from the UN (see Table 3.1) and the IIF (see Table 3.3) differ markedly with regard to coverage of different categories of countries and, in the case of the UN, for taking into account outflows linked to investment by developing country central banks of their foreign reserves abroad. Despite these differences, trends are not dissimilar.
3. The parallel here with the case of SMEs is clear. A modification was introduced to reduce excessive increase of the cost of bank lending for SMEs under the IRB approach, due to clear and strong pressure from the German authorities, which reportedly made this modification a pre-condition for backing Basel II.
4. The case for the introduction of purchasing power parity GDP (PPP GDP) as the (or an important) basis for quota calculation – rather than market exchange rate-based GDP – is a strong one. Using only GDP based on market exchange rates, as the current quota formula does, substantially underestimates the GDP of developing countries, because it underestimates the value of the non-tradable sector that tends to be larger in developing countries.
5. The Development Committee, which is formally known as the Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries, serves as a forum of the World Bank and IMF that facilitates intergovernmental consensus-building on development issues.

ANNEX 3.A

CORRELATION COEFFICIENTS AND CORRELATION FACTOR FOR THE TWO- AND THREE-FACTOR MODEL

Table 3.A.1. **Correlation coefficients**

Variable	Time period	Frequency	Developed / developed mean correlation coefficient	Developed / developing mean correlation coefficient	Test statistic (H0:Mx=My) critical value of 0.05% one-tailed test in parentheses
Syndicated	1993-2002	Monthly	0.37	0.14	3.33 (3.29)
ROA	1988-2001	Annual	0.10	-0.08	4.40 (3.29)
ROC	1988-2001	Annual	0.14	-0.11	6.92 (3.29)
GDP	1985-2000	Six-monthly	0.44	0.02	9.08 (3.29)
GDP HP	1950-1998	Annual	0.35	0.02	9.41 (3.29)
STIR	1985-2000	Six-monthly	0.72	0.23	11.09 (3.29)
STIRR	1985-2000	Six-monthly	0.66	0.22	10.93 (3.29)
GBI-EMBI	1991-2002	Daily	0.78	0.53	5.45 (3.29)
GBI-EMBI	1991-1997	Daily	0.90	0.74	4.64 (3.29)
GBI-EMBI	1998-2002	Daily	0.42	0.09	5.87 (3.29)
IFCI-COMP	1990-2000	Daily	0.58	-0.15	7.83 (3.29)
IFCG-COMP	1990-2000	Daily	0.58	-0.17	8.06 (3.29)

Source: Griffith-Jones, S., S. Spratt and M. Segoviano (2002), “Basel II and Developing Countries”, *The Financial Regulator*, Vol. 7, No. 2, September.

Table 3.A.2. **Correction factor for the two- and three-factor model**

%

Box 1. Diversification index	**Two-factor model correction factor**	**Three-factor model correction factor**
35	-	79
40	-	81
45	-	82
50	84	84
55	85	86
60	87	87
65	89	89
70	90	91
75	92	92
80	94	94
85	95	96
90	97	97
95	99	99
100	100	100

Source: BBVA (2004b), "The Two-factor Model for Credit Risk: A Comparison with the BIS II One-factor Model", *Risk Methodology*, mimeo, Madrid, January.

CHAPTER 4

THE POLITICS OF POLICY COHERENCE

By Ethan B. Kapstein[1]

Promoting the policy coherence for development agenda entails a commitment on the part of OECD member governments to economic and institutional reform and change. But since domestic arrangements for policy making and resource allocation tend to be sticky, the question arises as to whether there are particular political settings which are most likely to give rise to greater demands for policy coherence. Chapter 4 examines two hypotheses: first, that a country's level of spending on development assistance as a share of GNI reflects its domestic political-economic arrangements; and second, that the higher the level of development assistance, the greater the commitment to the policy coherence agenda. The analysis shows that the long-run political-economic orientations of OECD member governments, particularly their levels of domestic income redistribution, appear to have a significant influence on development assistance in particular, and to the policy coherence agenda more generally.

Introduction: political institutions and policy coherence

Developed country governments are increasingly confronted by the tremendous challenge of making national policies more coherent with their efforts to promote growth and reduce poverty around the world. An obvious example is provided by agricultural policy, where protection, subsidies, and trade-distorting export support of domestic farmers limit the market access opportunities for developing countries, in particular for crops such as cotton, rice, sugar, and fruits and vegetables. Domestic protection also takes the form of tariff escalation, which discourages investment in developing countries in value-added food processing industries, further undermining the potential contribution of agro-business to the promotion of sustained economic growth. While such policy incoherence may reflect the exigencies of domestic politics in industrial societies, their global cost to developing nations is demanding greater attention from policy makers, not to mention the public and "civil society" at large.

To date, much of the institutional work on policy coherence for development within and among OECD and European Union (EU) member states has involved inter-agency policy co-ordination to promote coherent national policies, as well as positions in multilateral negotiations in such institutions as the World Trade Organization (WTO). The OECD's Development Assistance Committee (DAC) has also played a useful role in promoting the policy coherence agenda, in part by highlighting it in the context of its reviews of DAC members' development programmes.

At a fundamental level, policy coherence for development involves reform and change of policies and institutions. In order to bring a state's development policies into closer alignment, reforms may have to be undertaken in substantive policy areas like trade, agriculture, and migration, in addition to building new institutional mechanisms to promote co-ordination. Yet most political and economic institutions are "sticky" by design and resistant to change; indeed, their purpose is to articulate and enforce the "rules of the game". Policy and institutional change often involves a process of articulating and enforcing new rules, and domestic actors who find themselves on the losing end of these changes may try to resist them.

This raises the question of whether certain political-economic governance structures will have particular advantages in advancing the policy coherence for development agenda. It is worth emphasising that, even in an age of extensive globalisation, the academic literature on comparative political economy has noted significant and enduring differences among OECD and EU member states with respect to such fundamental public policies as government spending on education, health and social welfare. Notably, levels of foreign aid spending as a percentage of

gross national product (GNP) vary enormously among these states as well. This relative absence of convergence suggests the strength and importance of domestic political-economic arrangements.

How do these differing institutional arrangements influence national development policies? And what are the implications of these differing institutional structures for the policy coherence agenda? These are the issues that will be addressed in this chapter. Specifically, we will examine the relationship between different domestic political-economic variables and national levels of development spending. Development spending could, for example, be related to whether a country's government has a "left," "right," or "centrist" orientation. It could be influenced by whether a government takes a parliamentary or presidential form, and if the former, whether the government is strongly majoritarian or based on coalitions of many different parties. Alternatively, the commitment to development assistance could be related to a country's internal political-economic structure, such as its level of income redistribution. By examining the comparative political economy literature and the available data, we will focus on some key hypotheses that may help us to understand the relationship – whether one clearly exists – between domestic politics and levels of spending on development policy.

This chapter has three sections. In the first section, we will use the Center for Global Development's *Commitment to Development Index*,[2] along with case study material drawn principally from the DAC's *Development Co-operation Reviews*, to analyse the extent to which DAC members have pursued policy coherence for the development agenda. Next, we will seek to explore the political correlates associated with these findings by testing some key hypotheses which relate domestic politics to levels of development spending. Suggestions for further research, along with policy recommendations will conclude this chapter.

Policy coherence for development: what do the data say?

According to the OECD, "policy coherence for development means taking into account the needs and interests of developing countries in the evolution of the global economy" (OECD, 2003). The OECD points out, for example, that "there is little point" in providing development aid for trade-capacity building if the exports of developing countries lack market access in industrial countries owing to the presence of trade barriers. Policy coherence therefore requires aligning national and multilateral policies in a way that promotes the chances of developing countries to achieve sustained growth.

DAC member countries appear to vary significantly in terms of their capacity to formulate and execute a coherent development agenda that integrates both development and other policies (*e.g.* trade and agriculture policies). But what are the key variables that impede the advancement of a more coherent development agenda? In some cases, there may be an absence of harmony between a national commitment to policy coherence on the one hand and regional institutional frameworks on the other. The Nordic countries, for example, have traditionally provided high levels of development assistance, yet the effectiveness of these policies for development may be undermined by EU trade and agricultural policies, over which the Nordic member states of the European Union also have some influence. In other cases, however, policy incoherence may be due to the internal structure of the domestic government. Federal systems in which power is widely diffused, or fragmented parliamentary systems in which governments are pieced together as coalitions of political parties with widely differing economic platforms, may face greater difficulties in promoting a coherent policy agenda than more unitary systems.

In this section we explore the political correlates of policy coherence both quantitatively and qualitatively. First, we examine the trade and aid scores obtained from the Center for Global Development's *Commitment to Development Index* (the index also includes scores for migration, investment and environment, but we will focus on trade and aid as being the most fundamental development-related *policies* of OECD member country governments).[3] We will see if those scores correlate with any obvious set of political variables. We will complement this approach with a qualitative look, by drawing some selective evidence about national commitments to policy coherence taken from the OECD's *Development Co-operation Reviews.*[4] As the data in Table 4.1 reveal, the Nordic countries generally receive high marks for the levels of foreign aid (as a percentage of gross national income [GNI]) they provide.[5] Two interesting exceptions stand out. First, Finland does not give comparably "Nordic" levels of assistance but is actually somewhat below the DAC average. Second, the Netherlands gives aid at levels that are similar to that provided, say, by Denmark and Sweden.

Table 4.1. **Commitment to development: trade, aid and policy coherence**

Country	Aid score	Trade score	Average	Comments on policy coherence
Denmark	9.0	6.8	7.90	"Denmark is supportive of actions … that promote policy coherence."[1]
Sweden	7.0	6.9	6.95	"… there is still a lack of capacity in integrating EU trade policy within development co-operation …"[2]
Netherlands	6.9	7.0	6.95	"Policy coherence has always been a key concern."[3]
Norway	6.6	1.0	3.80	Not available
Belgium	3.5	6.7	5.10	"internal consistency is an ongoing challenge … against a federalist background where there are manifest centrifugal tendencies."[4]
Switzerland	3.3	4.0	3.65	"a methodical effort has been made to improve policy coherence but for want of political backing it has not always been crowned with success …"[5]
France	3.1	6.8	4.95	"… nothing has been done to untie aid."[6]
United Kingdom	3.0	6.9	4.95	"Achieving coherence…is a priority for the United Kingdom …"[7]
Finland	3.0	6.5	4.75	"… policy coherence … falls short of being a clear statement …"[8]
Austria	2.8	6.8	4.80	Not available
Ireland	2.6	6.6	4.60	"Reforming agricultural trade policies can create difficulties in Ireland …"[9]
Spain	2.4	6.8	4.60	"Spain is one of the few DAC members to have explicitly integrated policy coherence into its legal framework."[10]
Portugal	2.2	6.9	4.50	"Unless the objective of poverty reduction is placed as one of the main considerations … the discussion on policy coherence may lack focus."[11]
Germany	2.1	6.8	4.45	"… the implementation of effective policy coherence will … require a substantial political commitment …"[12]
New Zealand	1.7	7.2	4.45	"… there is a high level of awareness … of development issues across a wide range of departments …"[13]
Australia	1.7	7.2	4.45	"…coherence … has … been endorsed as Australian government policy."[14]

Table 4.1. **Commitment to development: trade, aid and policy coherence (cont'd)**

Country	Aid score	Trade score	Average	Comments on policy coherence
Canada	1.7	6.6	4.15	"Canada's commitment to policy coherence … remains to be articulated in a comprehensive way …"[15]
Greece	1.5	6.7	4.10	"For Greece … policy coherence issues can be especially challenging."[16]
Italy	1.4	7.0	4.20	"There is no specific … mechanism for dealing with coherence …*per se.*"[17]
Japan	1.2	4.6	4.40	Not available
United States	0.8	7.7	4.25	"There is a strong need to identify and address development policy coherence issues in the US system."[18]
Average	**3.5**	**6.6**	**5.05**	

Notes: The following references are from *The DAC Journal*

1. OECD (2003), Vol. 4, No. 3, p. 187.
2. OECD (2000), Vol. 1, No. 4, p. I-39.
3. OECD (2001), Vol. 2, No. 3, p. I-31.
4. OECD (2001), Vol. 2, No. 2, p. II-43.
5. OECD (2000), Vol. 1, No. 4, p. II-44.
6. OECD (2000), Vol. 1, No. 3, p. I-85.
7. OECD (2001), Vol. 2, No. 4, p. I-45.
8. OECD (2003), Vol. 4, No. 3, p. 264.
9. OECD (2003), Vol. 4, No. 4, p. 47.
10. OECD (2002), Vol. 3, No. 2, p. II-35.
11. OECD (2001), Vol. 2, No. 2, p. I-45.
12. OECD (2001), Vol. 2, No. 4, p. II-43.
13. OECD (2000), Vol. 1, No. 3, p. II-49.
14. OECD (2000), Vol. 1, No. 2, p. II-41.
15. OECD (2002), Vol. 3, No. 4, p. II-41.
16. OECD (2002), Vol. 3, No. 2, p. I-53.
17. OECD (2000), Vol. 1, No. 3, p. III-47.
18. OECD (2002), Vol. 3, No. 4, p. I-63.

Source: Center for Global Development, *Commitment to Development Index* and OECD, *Development Co-operation Review* (various issues).

We can also observe an interesting disjunction in several cases between OECD member commitments to aid and to trade with developing countries. Norway, for example, scores very low on the trade score; conversely, the United States, which ranks at the bottom of the aid table, is the highest in terms of foreign trade.[6] Pursuing the political correlates of these differences would make for a useful follow-up to the present study; more on this in the concluding section.

In Table 4.1 we have followed the Center for Global Development's practice of simply averaging the scores on the trade and aid scales, though one could certainly make the case for a weighted score as well. For example, one could argue that the commitment to trade is more important in overall economic terms to developing countries than are foreign aid flows, and as a result we would weigh the two scores differently, with greater weight given to the trade score. Again, while we have taken the average score, the limitations associated with that approach are recognised.

As we can see, when the trade and aid scores are combined, Denmark, Sweden and the Netherlands do exceptionally well in comparison with most DAC member country governments. The question thus arises whether these countries share any

political-economic attributes that might help to explain their commitment to development policy. Interestingly, there is relatively little academic literature that explores the connection between domestic political-economic variables on the one hand, and development policy on the other. The literature that does exist focuses on foreign aid spending more narrowly. But despite this restricted focus, the answers to these questions may offer suggestive implications for the policy coherence agenda.

The political correlates of policy coherence

As already noted, research on comparative political economy has stressed the enduring significance of national institutions and political arrangements even in an increasingly globalised world. Further, this literature suggests that "parties and institutions matter, and that they do so not only domestically, but also with respect to foreign policy" (Therien and Noel, 2000). In particular, some authors have tried to demonstrate that the left-right orientation of a government influences its development policies and its foreign policies more generally. According to these authors, political parties with a "left-wing" orientation will promote more generous development policies than those that articulate more "right-wing" public policies (Therien and Noel, 2000).

We have tested some of the key hypotheses in the political science literature on the politics of development assistance using data drawn from Beck *et al.* (2001) along with data on foreign aid flows (used as a proxy measure of commitment to development policy) drawn from the DAC. Two of the most commonly found hypotheses in this literature are as follows:[7]

- **H1**: Left-wing governments will tend to give more foreign aid than right-wing governments.
- **H2**: Countries in which domestic levels of income redistribution are high (or "social democracies") will tend to give more foreign aid than less-redistributive or more "market-oriented" economies.

H1, which emphasises differences in budgetary priorities among left- and right-wing oriented governments, provides an assertion that is commonly heard about social spending generally and foreign aid spending in particular. We have explored it in two ways. First, replicating an approach first developed by Therien and Noel (2000), we have taken every DAC member for 1980 and 2000 and regressed aid spending as a share of GNI against the left, right, or centrist orientations of the government (again, the data on government type comes from Beck *et al.*, 2001). As Table 4.2 indicates, the relationship is utterly non-significant. There is no correlation between the political orientation of the government of the day and the levels of

foreign aid it provides *relative to other governments*. Left-wing governments in country Y do not systematically spend more on development than right-wing governments in country Z.

Table 4.2. **Political correlates of development policy**

Table 1.	Table 2. 1980	Table 3. 2000
Table 4. Left-right orientation	Table 5. .00 (.07)	Table 6. .03 (.06)
Table 7.	Table 8. R^2: 0.00	Table 9. R^2: 0.02
Table 10. "Nordic" dummy	Table 11. .33 (.13)	Table 12. .41 (.11)
Table 13.	Table 14. R^2: .26	Table 15. R^2: .39

Source: For left-right orientation, see Beck, T. *et al.* (2001), "New Tools in Comparative Political Economy: The Database of Political Institutions", *World Bank Economic Review*, 15: 1, pp. 165-176, September, www.worldbank.org, accessed 23 February 2005.

This leads, naturally, to a second question: do levels of aid change significantly *within* countries when governments switch from a left-wing to right-wing orientation or vice versa? To examine this question, we have taken time series data on OECD member governments from 1980-2000 and regressed the changes in aid spending against the changes in government. Again, the relationship is non-significant for each country. For example, countries with relatively frequent changes of government, including Denmark, Finland and France, show no correlation between these changes and their levels of spending on foreign aid.

In fact, that finding is also consistent with Therien and Noel, who go on to argue that it is not the immediate party-orientation of the government of the day that determines aid spending; rather it is the *persistence* of a particular orientation over long periods of time. What this means is that some countries seem to have more of, say, a "social-democratic" political-economic orientation, while others have more of a "free market" orientation, no matter the party that is in power at any particular moment. That orientation manifests itself visibly, for example in a country's commitment to domestic income redistribution; thus, some OECD member governments are much more redistributive than others. As a consequence of these long-run political-economic differences, the "right-wing" government of, say, a Nordic country, is likely to maintain a commitment to that country's particular social institutions and arrangements, such as relatively high levels of income redistribution, even though it may have significant policy differences with its "left-wing" counterparts with respect to the role of the private sector in the economy, the

generosity and duration of welfare state payments, and so forth. What Therien and Noel find is that when the persistence of a particular political-economic orientation (*e.g.* high levels of income redistribution and social spending *versus* low levels) is taken into account, the effects on foreign aid spending become much more powerful.

We have attempted to update and further specify their results (they paired 1980 and 1990; we pair 1980 and 2000) by regressing aid as a share of GNI against a "Nordic" variable, which seems a convenient proxy for relatively high levels of income redistribution, with the results again reported in Table 4.2. As we can see, the correlation is fairly significant; Nordic countries, which tend to have high levels of domestic income redistribution, seem to provide more aid than their non-Nordic counterparts.[8] The question that we must now ask is *why is that the case*? Why is there a "Nordic difference" when it comes to aid spending?

There is, of course, substantial literature in political science that has emphasised the distinctive nature of the social compact in Nordic societies, and their dedication to "humanitarian values" (Esping-Andersen, 1990). Still, why it is that voters choose or endorse these high levels of domestic income redistribution and foreign aid (which might be seen as the international corollary of domestic redistribution) remains an important topic for further research.

A recent body of literature, drawn from economics, may help to provide an answer. This literature is motivated by the apparent "puzzle" of unrequited transfers. As Mayer and Raimondos-Moller (2003) remind us, "a country that chooses its economic policies with the objective of maximising social welfare would never wish to become a foreign-aid donor". That is because foreign aid can be seen as a collective good. If one country provides it, then others would naturally wish to free ride. But such free-riding behaviour is more limited than one would predict. The question that naturally follows is *why, then, do these transfers occur*?

Mayer and Raimondos-Moller try to provide a theoretical response by building a political economy model which rests heavily on the median voter theorem, or the notion that government policies will closely reflect the preferences of an electorate's swing voters. They assert that:

> Foreign aid, as any actual economic policy choice, is determined through a political process in which all participants pursue their self-interest rather than … the objective of maximising a country's overall welfare. The political process can result in foreign aid giving if at least some people benefit from the country's role as a donor. … At issue, therefore, is whether the giving of aid to foreign residents can benefit some segments of the domestic population and whether the political process enables these

> winners to impose their will on the rest of society. (Mayer and Raimondos-Moller, 2003)

At first glance, this model does not seem to explain the actual patterns of aid among DAC member governments. For example, Mayer and Raimondos-Moller suggest that countries which are large exporters of food and weapons to developing countries would have a particularly strong interest in foreign aid (to help countries pay for these imports). Essentially, the owners of gun and butter assets would lobby governments to provide foreign aid, and the more heavily implicated the median voter is in producing these goods, the higher the levels of foreign aid they would support. If the model of Mayer and Raimondos-Moller provided an accurate reflection of DAC flows, we would expect France, United Kingdom and the United States – all significant arms exporters – to be much more generous in the amounts of aid they provide.

But the largest food and weapons exporter in the world is the United States, which ironically gives the smallest amount of aid of any DAC member as a percentage of GNI. To be sure, one could argue that these (among other) countries would provide even *less* development assistance than they do now, were it not for the presence of vested interests that lobby their governments for foreign aid. Testing that proposition empirically, however, is extremely difficult.

On the other hand, the median voter theorem suggests an intriguing hypothesis, which we will label **H3,** in terms of the policy coherence for the development agenda: *namely, the higher the share of foreign aid as a percentage of GNI, the greater the median voter's interest in government spending on aid*. In other words, even if we accept that development assistance arises for a multiplicity of reasons, only one of which is a direct reflection of median voter preferences (those preferences may not have a one-to-one relationship with government policy due to intervening variables like government and bureaucratic structure, which "shield" public officials to some extent from median voter preferences), the median voter may still demand accountability for the use of his or her taxes when it comes to election time (or to put this in other words, politicians will be more likely to exploit aid as an electoral "issue" the higher the level of spending). Governments that pursue incoherent policies will have a more difficult time persuading the median voter that their tax monies are being well spent, and for that reason we might expect to see a correlation between high levels of development assistance and a policy coherence agenda (again, to put this in other words, opposition politicians will be more likely to attack "ineffective" aid spending in countries where the amounts are relatively high).

Alternatively, one could argue that the median voter in Nordic countries has certain ideas about the relationship between income redistribution and political stability which heavily influence foreign policy in general and foreign aid in particular. For example, it is commonly held in the political economy literature that high levels of income inequality are more likely to breed political instability and conflict (Kapstein, 1999). If the median Nordic voter believes this to be the case, he or she might vote not only for higher levels of redistribution at home, but for higher levels of foreign aid as well.

To summarise the literature on the political correlates of development assistance, the strongest correlation that we can observe appears to be between Nordic countries and levels of foreign aid flows. *Why* these countries (along with the Netherlands) give so much aid remains, however, a puzzle that has not been fully solved. One intriguing explanation is found in their domestic levels of income redistribution (similarly high levels are found in the Netherlands). This raises the question of whether a domestic commitment to income redistribution finds its outward expression in the advancement of a world that is also more equitable. Further, we have suggested that countries which spend relatively large amounts on foreign aid will also have the highest commitment to the policy coherence agenda, perhaps because the median voter in these countries (or politicians seeking their votes) will have a heightened concern regarding the tax monies spent for that purpose.

Conclusions

This chapter has examined some of the political correlates associated with DAC member governments' commitment – or lack thereof – to coherent development policies. Using the available data it has found relatively strong support for the hypothesis that countries with high levels of income distribution tend to give more foreign assistance as a share of GNI than more market-oriented economies, and it appears that these countries also demonstrate a relatively strong interest in promoting the policy coherence agenda.

To be sure, it is likely that there is something beyond the preferences of voters that is reflected in the development policies of DAC member governments. After all, modern democracies have created formidable political institutions which provide some degree of autonomy in policy formation and execution. Further, a host of special interest groups invade domestic political-economic arrangements in an effort to seek rents from the system, which are then paid for by society at large. These and other political and ideological forces must be incorporated into a deeper

understanding of the political correlates of development policy and the demand for greater policy coherence.

As we pursue the politics of policy coherence, it will be both useful and necessary to develop more sophisticated quantitative definitions and measures of policy coherence – not to mention a more specific set of policy guidelines. Are free flows of capital and trade necessarily associated with an agenda that focuses on poverty reduction? What migration policies would promote the poverty-reduction objective? These and many other substantive questions need far more analysis than they have received to date.

In terms of quantifying policy coherence, we have also observed in Table 4.1 a disjunction in several cases between the "quantitative evidence" or rankings in terms of aid and trade scores *versus* the qualitative comments made by DAC examiners with respect to national development policies and programmes. Thus, several countries that have relatively low aid and trade scores nonetheless receive high marks for their efforts to promote the policy coherence agenda.

The politics and the policies of coherence for development thus remain relatively little understood. The objective of this chapter has been to review the academic literature that would appear to illuminate some of the key issues at stake, including the influence of government type and political orientation on development policy. If DAC members are to embrace the policy coherence agenda, they will need to have a clearer understanding of what coherence means and how it can be advanced within the context of their particular political-economic institutions and arrangements.

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NOTES

1. Ethan Kapstein is Paul Dubrule Professor of Sustainable Development, INSEAD. It should be noted that the opinions expressed and arguments employed in this chapter are the sole responsibility of the author and do not necessarily reflect those of the OECD or of the governments of its member countries.
2. The *Commitment to Development Index* may be found at www.cgdev.org, accessed 23 February 2005.
3. This is not to deny the importance of migration and environmental policies for development. It is simply to assert that if OECD countries wish to have an influence on the growth prospects of developing countries, then trade and aid policies are likely to be most decisive over a policy relevant time horizon.
4. It should be emphasised that some of these reviews are now several years old and one would expect national approaches to policy coherence to have evolved since they were written.
5. It should be noted that the Center for Global Development also seeks to assess the "quality" of aid as well as the quantity in this ranking.
6. Sara Dahlsten of OECD also points out that the United States provides significant amounts of development assistance through private charities and foundations, which is generally not the case among other OECD/DAC member country governments.
7. We have not tested certain hypotheses, for example whether parliamentary type matters, for the simple reason that the vast majority of DAC member governments have parliamentary systems based on proportional representation. In order to test patterns of aid spending against types of political-economic arrangement, one has to see where there is significant variance, so that changes in aid can be tested against some key variables that appear to differ across governments.
8. The robustness of the result, labeled R2 in the Table, is weakened somewhat due to the fact that Finland provides aid at below DAC-average levels, while the Netherlands, which is not counted as a Nordic country in the regression analysis, spends high above the DAC average.

CHAPTER 5

POLICY COHERENCE AND DEVELOPMENT EVALUATION: ISSUES AND POSSIBLE APPROACHES[1]

By Robert Picciotto

*Sound monitoring and evaluation arrangements help to minimise unnecessary incoherence between policies by contributing to evidence-based policy design and sound public sector management. Evaluation of policy coherence for development is an area that is largely unexplored. Based on a four-dimensional typology of coherence issues (*i.e. *internal, intra-country, inter-donor and donor-recipient coherence), Chapter 5 examines the rationale for and efforts towards coherence in the European Union, the United Nations, the international financial institutions, non-governmental organisations, and the OECD. It present the results of monitoring and rating efforts carried out to date, mainly in tracking progress towards achieving the Millennium Development Goals and through the Commitment to Development Index. It proposes concrete approaches, methods and a governance system for credible, objective evaluation of coherence, ending with a specific proposal to assess the OECD's horizontal programme on policy coherence for development.*

Introduction

This chapter outlines concepts, issues and options regarding the evaluation of policy coherence for development (PCD) in OECD member countries, an area of reflection that remains largely unexplored. Sound monitoring and evaluation arrangements help to minimise unnecessary incoherence by contributing to evidence-based policy design and sound public sector management. Opinion drives policy. Wrong opinions (or opinions driven by special interests) tend to produce bad policies. Independent evaluation replaces opinion with knowledge. It is driven by the public interest and aims to make authority responsible.

Evaluation determines the merit, worth and value of things (Scriven, 1991). It consists in collecting relevant evidence, identifying suitable evaluative standards and using methods of analysis that are valid and fair. It presumes that the object subjected to evaluation is adequately defined, as has been done for PCD in the author's Introduction to this volume and by others in subsequent chapters. Evaluation of PCD also presumes clear goals set and an implementation programme in place.

In relation to the four types of policy coherence identified in the Introduction (Type 1. internal, Type 2. intra-country, Type 3. inter-donor, and Type 4. donor-recipient), intra-country coherence has not been a focus of development evaluation because interest in evaluating non-aid policy issues had been limited until the advent of PCD. A January 2004 request to all members of the DAC development evaluation network to provide evaluation material relevant to PCD elicited no response[2]. The multi-donor evaluation of the Maastricht's Triple C (following pioneering work by the Policy and Evaluation Department of the Ministry for Foreign Affairs of The Netherlands) may address non-aid issues in a selective way but its main focus is likely to be on inter-donor issues.

Yet, unless development evaluation is refocused to reach out well beyond aid, the main defining feature of PCD (*i.e.* the identification of trade-offs and synergies *across* policy domains towards achieving development objectives) will not benefit from objective assessment. As a result, learning experience will be inhibited. This will undermine the progress of PCD, an urgent priority for improving the welfare of four-fifths of the world's population that live in the zones of turmoil and development.

This chapter examines the rationale for and efforts towards PCD in the European Union, the United Nations, the international financial institutions (IFIs), non-government organisations, and the OECD. It presents the results of monitoring and rating efforts carried out to date. Finally, it reviews options, approaches,

methods and governance relevant to the establishment of a credible PCD evaluation system. It asks challenging questions that could serve specifically to evaluate the success of the OECD's PCD programme.

PCD and the European Union

Article 130U of the Maastricht Treaty of 7 February 1992 sets out development objectives for the European Community (sustainable development, integration in the global economy, poverty eradication, democracy, the rule of law and respect for human rights). Article 130V (the coherence article) explicitly states: "the Community shall take account of the objectives referred to in Article 130U in the policies that it implements which are likely to affect developing countries." While vaguely worded, the provision is clearly pro-development and marks the first formal acknowledgment of PCD in a multilateral context.

To be sure, the Yaoundé agreements of 1964 and 1969 had already placed stress on the complete equality of the 18 African countries with the six EEC contracting partners. Article 11 presaged the coherence principle by mandating consultation with the associated states in the design of the Common Agricultural Policy. On the other hand, the "C word" only became current following a European Commission decision of May 1994 that reduced beef export subsidies that had been shown to hurt livestock farmers in the Sahel: "it is therefore necessary to take measures to end the serious *incoherence* that exists between the agricultural policy and the development policy of the Community."

Revealingly, the principle of *coherence* is connected to two other operating principles: *co-ordination* and *complementarity* (thus completing the trilogy of "the triple C") (Schrijver, 2001).[3] While co-ordination supports coherence, complementarity may constrain it. Thus, Article 130U (Article 177 in the Treaty of Amsterdam) stipulates that the development assistance policies of the Community shall be *complementary* to the policies pursued by member states; and the Community and the member states shall comply with the commitments they have made and take account of the objectives they have approved under the aegis of the UN and other international organisations.

Community activities do not prejudice the competence of European member states to participate in international bodies and conclude international agreements (Article 181). This confirms that *complementarity* holds sway over the other two Cs – coherence and co-ordination. Furthermore, the principle of *subsidiarity* (*i.e.* the affirmation of diversity and the preference given to local and national decision making over community decision making, provided basic European agreements,

policies and values are respected) could be viewed as a further constraint on "Type 2" and "Type 3" coherence. Furthermore, the treaty does not mandate implementation of PCD. Nor does it specify modalities for PCD. All in all, the PCD concept has legal implications in the European Union (EU) but there remains considerable ambiguity and room for manoeuvre in the actual application by member states.

In order to strengthen implementation of PCD within the European Union, an *informal network* has been established to connect *focal points* with responsibility for PCD. The network currently includes the European Commission, Austria, Denmark, Finland, Germany, Hungary, Ireland, Luxembourg, Netherlands, Spain, Sweden and the United Kingdom. It shares information, facilitates co-ordination and improves communications with respect to PCD issues of relevance to EU-level decision making, *e.g.* in relation to EU trade regimes affecting developing countries or the formulation of EU positions in international negotiations. Since its creation in October 2003, the network has taken up the sugar and cotton regimes, EU food and feed controls in third countries, and implementation of the pre-Cancun TRIPS/Health agreement.

PCD and the United Nations

The UN has made ample use of its convening power to promote PCD. At the Millennium Summit held in New York in 2000 – the largest gathering of heads of state ever held – all UN member states approved a historic declaration. It laid out specific goals to reduce human misery, enhance social development and promote environmental regeneration (UN, 2001b). Two years later, in March 2002, at the United Nations Conference on Financing for Development held in Monterrey (Mexico), a global development compact was forged and verifiable indicators of development progress were agreed (the Millennium Development Goals, or "MDGs").

For the first time in development history, general principles of development co-operation were universally endorsed. They match the adoption of improved policies and good governance by developing countries with the provision of more and better aid, debt reduction and the creation of a fairer and more open financial and trading system. This mutual accountability framework supports development objectives of unrivalled legitimacy. The global agreement to track human progress through 18 targets and 48 indicators is unprecedented.

The MDGs embody universal aspirations (poverty reduction, social development, environmental regeneration) and sum up the outcomes of numerous

international conferences. They have helped to strengthen development coalitions and have articulated a compelling rationale for aid to a largely sceptical public. To amplify their impact, the United Nations Development Programme (UNDP) has launched a global public information effort ("The Millennium Campaign") and provided intellectual leadership in promoting global public goods as a new rationale for aid (Kaul, Grunberg and Stern, 1999).

Of course, the intricacies of equitable, sustainable, inclusive development cannot be accurately summarised in the MDG scorecard. Income poverty reduction is critical, but so are the other freedoms that constitute human development. Reduced child mortality is important, but so is adult health status. Increased enrolment matters, but it does not guarantee learning. Nor do the MDGs invariably reflect country priorities. Concern has been expressed about their neglect of macroeconomic management, private sector development and infrastructure development, etc.

Most of all, the mutual accountability framework of the MDGs has not been backed up by binding government undertakings. For improved coherence in development to be reflected in results, it is not enough to agree on general principles and to adopt the rhetoric of results. The UN Secretary General's report to the Preparatory Committee of the Monterrey Conference included 87 recommendations. But the final communiqué of the conference, negotiated in advance, did not include clear action plans. Each country was left free to set its own course and formulate its own benchmarks.

The MDG framework, backed up by the poverty-reduction strategy paper (PRSP) system, demands more of developing countries than it does of developed countries. Only the eighth MDG addresses the responsibilities of OECD member countries and does so less precisely than the other seven goals. Most of the agreed indicators (35 out of 48) point south. Vast resources have been mobilised to monitor progress in developing country policies and programmes. No similar effort has been put into place to monitor the improvement of policies adopted by rich countries.

PCD and the IFIs

The international financial institutions have rallied behind the MDGs. They are assisting the UNDP in monitoring progress towards the MDGs. By the time the MDGs emerged, the new leadership of the World Bank had adopted operational emphases that largely coincide with the human development tenets of the UN system. As a result, relationships between the IFIs, the UN and the bilateral aid donors have improved, a significant contribution to Type 3 coherence.

In turn, the convergence of development objectives among donors has paved the way to innovation in development assistance – the PRSP process sponsored by the World Bank and the International Monetary Fund (IMF). It holds the promise of greatly facilitating donor-recipient relations. Despite teething problems,[4] the PRSP process has secured broad support across the development community. PRSP guidelines reflect the principles of comprehensive development, country ownership, broad-based partnerships and results orientation in line with the Millennium Declaration and the DAC *Principles of Effective Aid* (OECD, 1992).

Since the reliance on a limited number of indicators at the global level may not be responsive to country aspirations, the structure of PRSPs has been kept flexible while broadly consistent with the MDG logic. Domestically owned, the poverty-reduction strategy (PRS) process is designed to yield a common framework for the programming of domestic public expenditures and for aid co-ordination that is endorsed by country authorities. Tailor-made to each country situation, the PRS process has the potential of improving aid co-ordination – Type 3 coherence – and of acting as a two-way transmission belt between the global goals and national planning and budgeting systems – Type 4 coherence. The UN programming cycle is being adjusted to align with it.

Unfortunately, the overwhelming focus of the PRSP initiative has been on the assessment and the monitoring of developing country performance with virtually no attention to the impact of developed country policies on the likelihood of achieving results. Except in Tanzania (which has created an Independent Monitoring Group to keep track of aid quality), the IFIs have not provided the policy space or the capacity-building support required for developing country governments to carry out their own evaluations of aid effectiveness – let alone the overall policy performance of OECD member countries from a development perspective. Nor has much progress been made in incorporating rigorous PCD assessments within the IMF Article 4 reporting process.

PCD and NGOs

As part of the grand debate on globalisation, civil society organisations have played a leading role in sensitising public opinion with respect to the development incoherence of OECD policies. They have also helped to mobilise political support for specific policy reforms. In 1994, a non-governmental organisation (NGO) campaign decried the impact of European beef export subsidies on West Africa's rural welfare. In 1996, NGOs lobbied against a fisheries policy that allocated fishing rights and subsidies without regard to the impact on the coastal fisheries of

developing countries. A year later a proposed lift of the ban on cocoa butter alternatives faced strong opposition from development NGOs.

Similarly, the Highly Indebted Poor Countries debt relief initiative would not have been born without the Jubilee campaign. More recently, the international trade agreement on generic drugs in the run up to the Cancun meeting would not have materialised without the skilful work of major advocacy NGOs. No reform of OECD agricultural trade and subsidy policies is likely without continued, evidence-based civil society activism.

Equally, with respect to foreign direct investment (FDI), NGOs are likely to remain instrumental in sustaining the momentum of the corporate social responsibility movement and the harmonisation of social and environmental safeguard policies by international development and commercial credit and guarantee agencies. These are important elements of the PCD agenda.

Therefore, a proactive stance of NGOs *vis-à-vis* the private sector and developing country governments could be a critical contribution of NGOs to PCD. This will require less ideological opposition to FDI and greater concentration on the adoption of improved business norms and standards through advocacy campaigns and independent verification.

PCD and the OECD

Despite the manifold initiatives of the development community summarised above, the mutual accountability framework of the development system remains unbalanced. Progress in promoting Type 2 and Type 3 coherence (emphasised by the OECD Ministers) has lagged behind Type 1 and "Type 4" coherence. Most of the efforts devoted to policy coherence for development have been allocated to improved targeting, management and evaluation of aid agency programmes and projects. By contrast, issues of consistency that cut across policies, countries and agencies – Type 2 and Type 3 coherence – have been neglected.

According to the July 2003 OECD *Policy Brief*: "greater development coherence in OECD governments' policy stances will allow the benefits of globalisation to be more equitably distributed and shared" (OECD, 2003a). The OECD Horizontal Programme of Policy Coherence characterises PCD as involving "the systematic promotion of mutually reinforcing policy actions across government departments and agencies creating synergies towards achieving the agreed objectives". It embraces a broad agenda (trade, agriculture, governance of

development aid, investment and business climate, migration, environmental sustainability and technological development).

PCD in OECD goes beyond integrating the development dimension into the work of other policy communities. It also seeks to integrate the findings of those communities into the development co-operation policies of the OECD. Of course, politicians cannot be expected to forsake domestic concerns for the sake of PCD. But as they are presented with the development consequences of their decisions, they may think twice before adopting policies that may have deleterious impacts on poor countries.[5] Thus, the framers of the PCD horizontal initiative expect that concrete evidence and compelling analyses will help promote win-win outcomes, avoid flagrant policy contradictions, minimise the probability of negative impacts on development and amplify the voice of the global poor in the corridors of power, particularly when new policy initiatives are debated, designed and approved.

This is why the OECD PCD cross- cutting initiative is so timely and critical. It aims to ensure that each OECD member country pursues policies that support, or at least do not undermine, the development process in poor countries. Building political support for PCD among stakeholders so that OECD member countries initiate adjustment of a wide range of policies that affect developing countries would help accelerate progress towards the MDGs. For the OECD secretariat, this will entail delivery of analytical underpinnings for informed policy making, providing a platform for policy dialogue and monitoring of PCD performance.

As proposed by the DAC Chair, the OECD will need move beyond the traditional focus on making development assistance more effective – Type 1 coherence – to tool up to promote the creation of analytical capacity on coherence issues; support research on the impact of rich countries' policies on poor countries; commission "just in time" coherence analyses; conduct political economy assessments geared to strengthening public support for increased aid and other development-friendly policy reforms; and strengthen PCD monitoring and evaluation (OECD, 2003b). The latter is critical to the credibility of the horizontal programme. As currently framed and resourced, the OECD peer group review system does not deliver rigorous assessment of PCD performance at the country level since it does not respond to uniform standards – and remains heavily dependent on the degree to which individual OECD governments willingly contribute information and analyses on PCD issues.

PCD monitoring

The UNDP has completed 44 country reports that track MDG progress. It has done so in close consultation with partners in the UN Development Group, other UN partners, the World Bank, IMF, OECD and regional groupings and experts. The UN Department of Economic and Social Affairs is reporting on progress towards the goals at the aggregate level.

In parallel, the World Bank has launched a new series of "Global Monitoring Reports" addressed to the Development Committee of World Bank/IMF Governors. These reports deal with the policies and actions for achieving the MDGs and related outcomes. But they are heavily focused on poor countries' performance and have only begun to address the progress made by developed countries in meeting their MDG obligations. They are doing so in aggregate terms and are selective: they cover quality of macro-financial policies supportive of growth and stable capital flows; the quantity and quality of aid, debt relief, trade policies and global public goods.

In February 2004, a roundtable on managing for development results sponsored by the multilateral banks and the OECD's DAC endorsed core principles for results-based management and committed to focus their operational programmes on country results, harmonised reporting and capacity building in monitoring and evaluation and national statistics. A strong agenda was adopted in the Paris Declaration on Aid Effectiveness (March 2005). But here again, the focus of the proposed monitoring efforts remains on the development effectiveness of country-level development assistance programmes and projects. No attention to the rules of the game of the global economy is envisaged.

Rating PCD performance

Given the limited focus of official development agencies on Type 2 coherence issues, it is fortunate that development think tanks have begun to look into PCD. In particular, the Center for Global Development (CGD) has published a Commitment to Development Index (CDI) (Birdsall and Naim, 2003)[6] that aims to shift public attention from the policies of the south to the policies of the north. The CDI is innovative and helpful since it helps to rectify the mental construct according to which the shortfalls being witnessed in the progress towards the MDGs[7] can be attributed solely to ineffective aid, poor governance or weak policies in developing countries.

The new scorecard seeks to generate incentives for "laggards" in the donor community to clean up their policy act. The publication of the index in *Foreign*

Policy on a regular basis is meant to raise public awareness of the responsibilities borne by the industrialised democracies for the state of the world. The logic of CDI is straightforward: the policy performance of individual OECD countries is rated along six dimensions using plausible quality indicators for which reasonably accurate data are available.

For example, the aid component of the index adjusts gross aid flows to take account of principal repayments, administrative costs, technical assistance costs and tied aid. It addresses aid quality through a selectivity index that favours aid directed to poor countries and penalises aid allocated to countries with weak governance. But the first edition could not capture aid fragmentation that contributes to the inefficiency of aid delivery.[8] Nor did it incorporate adjustments for the share of aid directed to basic human needs[9] or the degree of support provided through budget support, pool funding and other flexible forms of aid.

The focus on tariffs and the limited range of non-tariff measures covered by the index has yet to capture the extensive restrictions on trade in services – an area of growing interest and value to developing countries. The bundling of data on non-trade barriers masks the restrictive impact that frivolous anti-dumping actions, complex regulations, and perverse enforcement standards have on trade flows. The index also fails to take account of the impact of preferential arrangements and the predilection for bilateral trade agreements displayed by the European Union and the United States.

The absence of intellectual property from the index is unfortunate. Tailor-made surveys might have addressed the extent to which individual rich countries: *(i)* patent products and processes already in use in developing countries; *(ii)* enforce copyright protection that discourages developing countries' access to knowledge; *(iii)* hinder or facilitate poor countries' access to knowledge-intensive products of relevance to poverty reduction (*e.g.* in agriculture or health); *(iv)* contribute to the transfer of science, technology and knowledge towards developing countries; *(v)* assist developing countries in the preservation of indigenous knowledge.

The CDI uses rich countries' contributions to UN peacekeeping operations as a proxy for the quality of security policies pursued by rich countries. This is misleading considering the massive arms trade flows originating in the same countries.[10] The index does not capture the enormous waste of resources associated with excessive military expenditures (O'Hanlon, 2002).

Finally, the CDI uses the same weights for all six dimensions. Not enough is known to make educated estimates of the relative importance of the index components (just as the CGD framers did when constructing individual ratings for

each of the components). Research models[11] estimate the welfare benefits of trade liberalisation for agriculture and manufactures to range anywhere from USD 108 billion to USD 760 billion for developing countries. Models including liberalisation of trade in services raise the benefits by a factor of 4-5 (World Bank, 2002).

Similarly, it makes little sense for the index to give the same weight to aid (which contributed about USD 49 billion in net official financing to developing countries in 2002) as to private investment (which contributed about USD 163 billion) or to remittances from migrants to developing countries (estimated to be at least USD 80 billion) (World Bank, 2003). To be approximately right is better than to be precisely wrong. Using weights that capture estimates of relative magnitudes of impact would improve the index and significantly change the country rankings.

In time, CGD expects to carry out impact research assessments that may provide reliable assessment of weights and illuminate policy choices.[12] To increase the legitimacy of the CDI and its ownership in developed and developing countries alike, an independent oversight mechanism focused on the validity of the methods and of the data that underlie CDI construction may need to be considered.

PCD evaluation approaches

It is clear that the traditional approach to development co-operation should be reconsidered to give more emphasis to the higher plane of global policy. Ongoing PCD initiatives are still few and are yet to bear fruit. Today's development business still focuses on the design of projects and programmes within developing countries. It fails to give explicit and targeted consideration to the global enabling environment within which these activities are implemented. This "path dependence" will have to be broken to make globalisation work for all – the poor as well as the rich.

The implications of the necessary shift in development priorities for evaluation are fundamental. To explore them, the mutual accountability framework of the Monterrey consensus is a good place to start. The new compact delineates shared development objectives embedded in the MDGs. It defines the reciprocal obligations of development partners: the responsibility for poverty-reduction policies and governance improvements lies with poor countries while reform of the global "rules of the game" (MDG8) is assigned to rich countries. For OECD evaluators, this new fiduciary architecture for global development implies a shift in evaluation priorities from traditional project and country programme evaluations towards the global plane.

Currently, development evaluation relates development outcomes to the design of aid programmes and projects, and the domestic policy and institutional environment. They treat OECD country policies as given and "exogenous". PCD evaluation would shift the focus of analysis towards global public policies and make them endogenous. This is not a trivial change. It will add a colossal element of complexity to the evaluation process. The enormity of the challenge may explain the limited progress made in tackling it. But a start must be made. Breaking the problem up into manageable components will be essential to progress. To this end, several evaluation options can be considered. They are outlined below.

First, just as development evaluation units currently arrange for systematic reviews of individual projects and country programmes, PCD evaluation could tackle systematic *independent multi-donor evaluations of international collaborative multi-country development programmes* currently in place to deliver global public goods, share knowledge across countries or set business and/or professional standards. The number of such programmes has increased exponentially in recent years and they have largely escaped the scrutiny of evaluators even though serious questions are being raised about their governance, their efficiency and the results achieved.

Second, PCD evaluation could gradually take on vertical *multi-country reviews of individual policies* (aid, trade, migration, etc.) on a regional or global basis. Such reviews would require assessments of impacts of recent or proposed policy shifts on economic and social conditions in representative countries, both developed and developing, together with the compensatory arrangements proposed for losers in the adjustment process. Priority should be given to policy vectors that are the subject of new international agreements, well ahead of their formal negotiations.

Third, part of the PCD evaluation challenge could be met by systematic assessments of the PCD aspects of national policies on a horizontal basis. This could consist of self-evaluation (not unlike the GPRSP [Growth and Poverty Reduction Strategy Paper] approach being piloted by some Nordic donors and the Netherlands). In order to ensure symmetry with the PRSP system in place within poor countries, it could be combined with independent evaluations and oversight (guidelines, advisory support, etc.), say, by the OECD secretariat and/or the Development Committee.

Fourth, a privileged unit of account for PCD evaluations might be a sample of representative developing countries within which the *development impact of specific reforms* in OECD policies (*e.g.* increase in quality or quantity of aid, gradual removal of cotton subsidies, reduced immigration restrictions, etc.) would be tracked and recommendations made both to OECD and to the countries concerned in order

to enhance the synergy of policy reforms and to improve the design of aid programmes.

Fifth, considering that the OECD proposes to target such policy areas as investment, business climate, technology and environmental sustainability as well as sectors such as agriculture and health where the private sector plays a major role, PCD evaluations might include *independent assessments of the impact of regulatory regimes and standards* (whether voluntary or compulsory) on developing countries.

Sixth, it might be useful to produce and/or sponsor or commission an *annual progress report on PCD* that would build on the CDI index but enhance its legitimacy and evaluative content through formal participation by governments, the private sector and the civil society. Box 5.1 summarises the results of a limited survey with respect to PCD evaluation priorities.

Box 5.1. **Survey respondents' views about PCD monitoring and evaluation priorities**[13]

According to the survey results, 11 out of 14 respondents were of the opinion that the UN and the IFIs should devote the same level of effort for the monitoring and evaluation of rich countries' policy performance (MDG8) as they do for poor countries' performance. But views were equally divided as to whether rich countries should be tasked to prepare reports on the impact of their policies on growth and poverty-reduction (GPRSPs). Some of the respondents questioned the realism of the proposal. Others wondered whether GPRSP reports prepared by governments would be credible.

Both horizontal PCD reviews in individual OECD countries transversal reviews across OECD countries ranked high in respondents' priorities. Next were independent and self-evaluations of global public goods programmes linked to the MDGs. Substantial support was also voiced for annual reviews of PCD that would go beyond the CDI. Full involvement of developing countries in the PCD evaluation process was advocated by most respondents. Technical support to build their evaluation capacities was also considered critical.

Again, 11 out of 14 respondents pointed to a need for systematic monitoring and evaluation of international conventions and regulatory regimes. Close to 50% of the respondents thought that responsibility for such evaluations should be allocated to the international bodies that manage them or a new independent evaluation organisation that reports to the UN or the Development Committee.

The majority of (12 out of 14) respondents stated that the UN, the IFIs and donors should use more of their research funding for the assessment of the development impact of rich countries' policies: 10 out of 14 respondents would assign these resources to developing country research institutions. Respondents would also support evaluations of the development effectiveness of FDI by developing country institutions in parallel with voluntary standard setting and monitoring by private companies. Involvement of NGOs and UNCTAD/IFIs was also endorsed, but to a lesser degree.

PCD evaluation methods

The toolkit of the evaluation profession is well stocked to deal with PCD, provided the objects selected for review are "evaluable" (Wholey, 2002) and the resources allocated are commensurate with the task. For example, programme evaluation theory is well adapted to the assessment of global collaborative programmes. Similarly, meta-evaluation methods combined with theory-based evaluation techniques (Weiss, 1998) would constitute evaluative instruments of choice for multi-country PCD evaluations of individual policy vectors. GPRSPs and country impact evaluations would require the deployment of case-study and policy-research tools. The battery of "new public management" evaluation tools could be brought into play for tackling assessments of regulatory regimes and corporate social responsibility standards.

Thus, the challenge raised by PCD is more a challenge to development evaluation than it is to the overall evaluation profession. On the other hand, development evaluators bring considerable assets to the PCD evaluation task. When connected to organisational performance mechanisms and backed by independence in evaluation, development evaluation strengthens accountability.[14] It also promotes realism in planning, programming and budgeting. Finally, it facilitates organisational learning as it induces evaluators to assess the relevance of policy goals and operational practices.

The objectives-based approach (Hanna and Picciotto, 2002) would be well adapted to PCD evaluations. Typically, development evaluators compare results (outputs, outcomes and impacts) to the goals set at the outset of an aid intervention. This provides a useful link to internal management mechanisms. Equally, development evaluators have ample experience with the evaluation of partnerships that lie at the core of the PCD evaluations challenge (Liebenthal, Feinstein and Ingram, 2004).

PCD evaluation would add a twist to the traditional approach of development evaluators by teasing out the balance of interests that are actually served by the policies, programmes and projects of development assistance agencies, in a transparent fashion. From a methodological standpoint, the injection of PCD would force development evaluators to un-bundle programme objectives and impacts among development partners and assess the balance of costs and benefits among them. This would help improve the accuracy and credibility of assessments and strengthen the participatory dimension of the evaluation process.

Equally, development policies aiming at minimising the negative externalities of programmes and projects could be emulated in the management of PCD

programmes. Just as the social and environmental assessments are used as part of the appraisal of industrial and infrastructure projects, new "PCD impact assessments" might be considered when major policies are screened within an OECD member country. In time, this could lead to the adoption by OECD of *safeguard PCD standards* based on the Hippocratic principle of "first, doing no harm". Such policies would be informed by past *impact assessments* and guide future impact assessments. This would also provide a legitimate framework for *independent verification* mechanisms.

Another potential extension of development evaluation practice to PCD management would involve the systematic use of *process evaluations* to address PCD aspects. Such evaluations would address the relevance, efficacy and efficiency of PCD institutional arrangements at the national, regional or global level. They would examine: *(i)* co-ordination arrangements and participatory mechanisms; *(ii)* the quality of analytical capacity; *(iii)* the guidelines for policy making; *(iv)* the standards for assessing trade-offs among primary policy objectives and developing country interests; and *(v)* the monitoring and evaluation arrangements.

Evaluation governance

Methodological rigor is not sufficient to ensure credibility of evaluations. The design of evaluation governance to guarantee independence, objectivity and "value added" is of equal importance. This involves special challenges for PCD. Organisational design models that have proven effective in national and multilateral settings for development evaluation may not be applicable to PCD evaluation. Whereas development evaluation typically operates within a sovereign government or organisation, the achievement of policy coherence from a development perspective involves reviews of actions taken by several sovereign nations and autonomous organisations.

On the other hand, there is no reason why the same principles that underlie the design of sound development evaluation structures should not be applicable to PCD evaluation. First, the credibility of the evaluation function hinges on an arm's length relationship with line managers and policy makers. Second, its usefulness depends on its capacity to influence policy formulation and decision making (independence is not isolation). Third, its integrity requires compliance with the same principles of accountability, learning and transparency that it is designed to promote. These principles lead to organisational solutions that combine self-evaluation with independent evaluation. Contestability of self-evaluation findings by independent evaluation and oversight of self-evaluation standards by independent evaluation constitute basic features of sound evaluation governance.

The diversity of evaluation approaches needed to capture the many facets of PCD preclude a single organisational model. But some of the lessons drawn from experience in joint development evaluations are likely to have relevance for PCD evaluations: *(i)* the major stakeholders should be involved in the design of evaluation objectives, standards and methods; *(ii)* their respective responsibilities and obligations should be agreed at the outset; *(iii)* the evaluation team should be endowed with considerable autonomy; *(iv)* adequate skills and resources should be provided for the conduct of evaluation and the dissemination of its results.

Last but not least, credible PCD evaluation will imply a serious effort to involve developing countries in the process. This will call for a major commitment to evaluation-capacity development from donors. It will also call for evaluation funding and governance arrangements that give substantive control of a major segment of the PCD agenda to developing country governments, organisations and citizens. Just as development projects and programmes executed by poor countries have benefited from evaluations by donor organisations controlled by rich countries over the years, it would make sense for rich country policies that affect poor countries to benefit from evaluations carried out by evaluation organisations controlled by poor countries.

Issues for further consideration

How might results in PCD be assessed? The answer to this question depends on how results are defined. Taking OECD's horizontal programme on policy coherence as a case in point, this means articulating the specific goals of the OECD:

- Level 1: PCD aims to promote a "whole of government" approach in OECD member countries (input).
- Level 2: PCD aims to minimise the negative impact on developing countries of policy initiatives taken to achieve domestic goals (output).
- Level 3: PCD aims to encourage adjustment of OECD countries' policies to enhance the development performance of poor countries (outcome).
- Level 4: PCD aims to make globalisation work for the poor and achieve the MDGs (impact).

The implications of these four evaluation levels on evaluation governance and methods might best be taken into account by reflecting on the following questions:

- Level 1: What evaluative criteria should be used to assess the extent to which a "whole of government approach" has been implemented? Should

these criteria include quality of analyses and dissemination; changes in policy-making structures and processes; extent to which coherence issues enter policy debates; extent to which decisions are affected by analyses provided?

- Level 2: Should PCD be assessed in terms of the relevance of the issues addressed by the PCD programme; the efficacy of the analysis and its delivery to policy makers; the efficiency of these processes; the changes they induced in policy decisions and the extent to which actual policy decisions were influenced by the PCD programme?
- Level 3: Should PCD be assessed in terms of actual shifts in the development effectiveness of OECD countries' policies (before and after analysis) and the relevance of these shifts to developing countries' economic and social prospects? Or should the evaluation seek to define a counter-factual (with-without analysis) and compare the development effectiveness of actual decisions with those that might have been taken in the absence of PCD?
- Level 4: Should PCD be assessed in terms of the actual progress towards the MDGs attributable to changes in OECD policies? Should the benefits foregone by OECD member countries to achieve PCD be netted out? How can the contribution of shifts in developing countries' policies (Type 4 coherence) to the goal be netted out?

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NOTES

1. This paper was originally produced by R. Picciotto (Visiting Professor, King's College, London and former Director-General, Operations Evaluation, the World Bank) as a background paper, "Policy Coherence and Development Evaluation: Concepts, Issues and Possible Approaches", for the OECD Workshop on Institutional Approaches for Policy Coherence for Development, held in Paris on 18-19 May 2004. It was commissioned in order to prompt debate. It should be noted that the opinions expressed and arguments employed in this chapter are the sole responsibility of the author and do not necessarily reflect those of the OECD, DAC or of the governments of its member countries.
2. Development Assistance Committee Network on Development Evaluation. *Policy coherence for Development: Request for relevant material from evaluations.* First meeting, 15-16 January 2004 (Room document), Paris.
3. The Dutch focal point for PCD has since added another "3Cs" to the PCD lexicon: capacity, co-ordination and concrete targets.
4. While the PRSP process requires involvement of the private sector, civil society organisations and parliamentarians, there are concerns among voluntary organisations with the extent to which review of the PRSP by the IFI boards inhibits genuine participation.
5. For example, the EU Ministers announced on 22 March 2004 that they would cut off aid to countries not co-operating in the fight against terrorism (*International Herald Tribune*, 23 March 2004).
6. The second version of the index was not available in time for review in this paper.
7. ActionAid's MDG report card at half term is: D for poverty reduction; C for education; C for gender; F for child mortality; D for maternal health, F for diseases and E for the environment. ActionAid (2002), *Halfway There? The G8 and the Millennium Development Goals in 2002*, London.
8. Donor fragmentation has risen by over 25% according to a background note prepared by Knack, Stephen and Rahman for the *World Development Report 2004*. Thus, the Development Gateway now includes records for approximately 340 000 projects. Tanzania alone has nearly 7 000 projects funded by 80 donor organisations.
9. The international community has endorsed an allocation of 20% while the current share is about 11%.

10. According to the US Congressional Research Service, *Conventional Arms Transfers to Developing Nations, 1994-2001*, out of USD 16 billion of official arms transfers to developing countries, the United States accounted for 40%; Russia 23% and France 7%. Conventional arms used in developing country conflicts contribute to about 300 000 deaths annually.

11. The high end of the range is drawn from Dessus *et al.* (1999), "Multilateral Tariff Liberalisation and the Developing Countries", *OECD Development Centre Brief No. 18*, OECD, Paris. It is based on a dynamic model with productivity growth. The low end of the range is by Anderson *et al.* (2000), "Potential Gains from Trade Reform in the New Millennium", paper presented to the Third Annual Conference on Global Economic Analysis, Monash University. It is based on a static steady state model.

12. A research proposal for impact research underwritten by the Global Development Network following workshops sponsored by the Global Policy Project, the OECD Development Research Centre and the Centre for Global Development is under preparation.

13. A questionnaire was addressed to the evaluators of the DAC Network on Development Evaluation and to selected officials and staff of the World Bank, UNDP, IFPRI and the Centre for Global Development. The response rate was about 14% but the quality of submissions was high.

14. Unfortunately, most development organisations are not equipped with genuinely independent evaluation organisations and they have tended to use results-based management more to enhance planning than to increase accountability. With the exception of the World Bank and some regional development banks, RBM systems used in development agencies have lacked independent ratings of professional quality and institutional performance in their scorecards.

ANNEX A

OECD ACTION FOR A SHARED DEVELOPMENT AGENDA

From the OECD Council At Ministerial Level, Final Communiqué, 16 May 2002

OECD's role and strengths

1. Contributing to global development is a key objective of the OECD. Its founding Convention calls upon the OECD to promote policies "designed to contribute to sound economic expansion in member as well as non-member countries in the process of economic development." [Article 1(b)]. Given increased interdependence, this objective is even more vital today in order to achieve poverty reduction and sustainable development globally. The principles and values that the OECD promotes – commitments to democracy, market-based economies and open, rule-based, and non-discriminatory trading and financial systems, supported by good governance – are essential to achieving our ultimate goal of the economic and social well being of all people, in a way that respects diversity and cultural identity.

2. OECD's strengths include a multidisciplinary capacity for analysis and policy dialogue, its sharing of best practices and monitoring of its members through peer review, and extensive policy dialogue and capacity building activities with more than 70 non-member economies, international organisations and other stakeholders. The Development Assistance Committee (DAC) provides a capacity to foster amongst donors concerted, well co-ordinated, effective and adequately financed international efforts in support of development and poverty reduction in developing countries.

3. The building blocks for achieving the internationally agreed goals of the Millennium Declaration are now in place, supported by a broadly shared view that effective development calls for a comprehensive, partnership-based and results-focused approach. Developing countries have primary responsibility for their economic and social development, establishing good governance and sound policies to mobilise domestic resources and attract private investment, while developed countries give increased attention to the impacts of their policies on developing countries, and assist developing countries, in particular least developed countries (LDCs), in their efforts to build the capacity necessary to make effective use of

trade, investment and aid in support of poverty reduction and sustainable development.

How OECD contributes

4. The OECD, for its part, will build upon its strengths to advance this shared development agenda in the following ways:

Encouraging policy coherence for development

5. Successful poverty reduction requires mutually supportive policies across a wide range of economic, social and environmental issues. Through its programme on policy coherence for development, the OECD will enhance understanding of the development dimensions of member country policies and their impacts on developing countries. Analysis should consider trade-offs and potential synergies across such areas as trade, investment, agriculture, health, education, the environment and development co-operation, to encourage greater policy coherence in support of the internationally agreed development goals.

6. By increasing understanding of the development benefits of rules-based trade and investment, such work will help to reinforce our efforts, including promoting the better integration of developing countries into the multilateral trading system, to achieve more open markets both between developed and developing countries and among developing countries themselves to allow for export-led growth, and further our aim to improve market access to the goods of developing countries, and particularly LDCs. Supporting developing countries' governance and policy capacities

7. The OECD will continue to work with developing countries and countries in transition to help them identify and meet key human and governance capacity needs, including through use of information and communication technologies. OECD Global Forums and regional dialogue can support developing countries' efforts to build good governance and market-supportive institutions conducive to mobilising domestic resources and attracting investment capital. Such resources are critically important to developing countries' efforts to achieve sustained economic growth and support their capacities to address vital environmental, educational, health and other needs. We welcome initiatives at the regional level, such as the New Partnership for Africa's Development (NEPAD), and stand ready to share the OECD's experience and expertise, notably on peer reviews, in support of a sustained

commitment to strengthen political and economic governance. Improving aid effectiveness and ensuring adequate aid volume

8. Aid remains an important policy instrument and complement to domestic and international private capital for reducing poverty, preventing conflict, promoting good governance and creating an enabling environment conducive to achieving private sector-led growth. The OECD, where the world's major donors meet, has a key role in improving aid effectiveness, thereby sustaining the case for aid volume. Peer review in the DAC is an important tool in support of this role. The OECD is working to reduce the complexity of aid management procedures in collaboration with multilateral aid agencies and developing countries, and to ensure effective implementation of all aspects of the OECD/DAC Recommendation on untying aid to the least developed countries.

Strengthening partnerships and accountability

9. The OECD will strengthen its partnerships with non-members, in particular developing countries, as well as with international organisations and other stakeholders through analytical work, policy dialogue, and advice. A broader and more effective dialogue will improve the quality of our efforts to support development. The OECD will account for its actions to advance this shared development agenda through regular review and reports on progress.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(43 2005 17 1 P) ISBN 92-64-01014-9 – No. 54299 2005

The Development Dimension

Fostering Development in a Global Economy

A WHOLE OF GOVERNMENT PERSPECTIVE

What does policy coherence for development mean? Increasing global integration through trade, capital and labour mobility brings increasing mutual responsibilities and mutual policy repercussions. The 21st century will witness a rapid catch-up phase in economic growth for many non-OECD economies. Shifting shares of economic power call for commensurate changes in voice and influence in international economic and financial governance. In the light of intensified global linkages and policy spill-overs, the pursuit of policies by OECD countries that are harmful to the developing world is bound to backfire on the OECD area itself.

These realities call for greater coherence between the various OECD country policies that shape and impact today's rapidly evolving global economy. To be convinced of the need to ensure policy coherence, analysts and decision makers need to understand the trans-boundary implications of policy making.

In response, this volume brings together reflections by an internationally renowned group of scholars and policy experts:

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ISBN 92-64-01014-9
43 2005 17 1 P