

POLICY COHERENCE TOWARDS EAST ASIA: DEVELOPMENT CHALLENGES FOR OECD COUNTRIES

by

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OECD countries face at least five major challenges for promoting policies that are consistent with their development goals:

- ensuring security and political stability;
- anticipating the impacts of their macroeconomic policies on developing-country growth;
- increasing both market access and capacity building for developing economies;
- supporting governance structures that help maintain financial stability;
- improving aid effectiveness.



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Introduction and Overview

The East Asian development experience needs to be better understood — especially the region’s clustered, sequential development process and neighbourhood effects linking economies at different levels of industrial development. How have different policy vectors transmitted by OECD countries, notably in the areas of trade, investment and aid, contributed to the development of the region? To what extent have the impacts of OECD-country policies depended on the capacity of East Asian economies to respond through their own public policies?

Drawing upon Chapter I of the forthcoming publication (Fukasaku *et al.*, 2005), this Brief sketches out the main story lines of what has happened to East Asia over the past decades, particularly since the mid-1980s, through the lens of OECD countries’ “policy coherence for development”. It also discusses key policy agendas for the region, draws lessons for other developing regions and identifies major challenges ahead for policy coherence in OECD countries.

The Development Impact of OECD-Country Policies: A Case Study of East Asia

The OECD 2002 Ministerial Meeting issued a statement on development, calling upon the OECD to “*enhance understanding of the development dimensions of member country policies and their impact on developing countries*”. The OECD has responded to this ministerial mandate by launching an OECD-wide programme on policy coherence for development (OECD, 2003c).

The term “policy coherence” encompasses policy interactions at several levels. Internationally, coherence is needed among policies applied by different institutions as well as in the positions that countries take in them. At the national level, coherence refers to the consistency between objectives and instruments applied by individual OECD countries in a given policy area, such as development co-operation, as well as between objectives in different areas, such as aid and trade, in light of their combined effects on developing countries. Thus, the problem of policy incoherence for development arises when the objective of policy undertaken in a particular field — such as aid policy or transitional preferential arrangements — gets undermined or obstructed by actions of government in other policy fields — such as trade protection and agricultural subsidies. The OECD’s programme focuses on identifying such mismatches in specific policy contexts and suggesting action to ensure that

OECD countries' policies help promote or at least do not harm the economic interests of developing countries¹. Furthermore, OECD work on this topic seeks to facilitate and support efforts of both OECD and developing countries to encourage the systematic promotion of mutually reinforcing policy actions, including aid, but extending beyond it. The types of OECD-country policy interactions that may affect development outcomes include, *inter alia*, those resulting from the interplay of policies in the fields of agriculture, trade, investment, migration and aid.

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

Key Coherence Lessons from East Asia

Several developing economies of East Asia simultaneously experienced major turnarounds in their clustered, sequential development process in the early 1970s and again in the mid-1980s (see the next section on this point). Behind this process, significant changes in the international economic environment indeed occurred. In macroeconomic policy, easy monetary policy among OECD countries in the 1970s led to low real interest rates, and the Asian NIEs (newly industrialising economies, i.e. Chinese Taipei; Hong Kong, China; Korea and Singapore) found it convenient to finance their strong investment demand by borrowing petrodollars recycled through banks in London and New York (Frankel and Roubini, 2003). Relocation of labour-intensive manufacturing among East Asian economies was also facilitated by successive rounds of real effective yen appreciation, particularly in the wake of the Plaza Accord on the dollar-yen currency realignment in September 1985. In the early 1990s, real interest rates in the United States and other OECD countries were once again low, so that international capital went to East Asian and other emerging economies to earn higher returns. Thus external macroeconomic factors exerted an important impact on the East Asian economies through trade and financial linkages.

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

International aid, largely in the form of concessional loans, supported the developing economies' growth by focusing on the importance of foreign trade and inward direct investment, through financing economic infrastructure and human resource development. International aid also helped to strengthen recipient countries' policy frameworks and institutional fundamentals, as in China's reforms. The East Asian economies were able to create a trade-FDI nexus with their market-friendly policy environments (good investment climate) and their institutional and human capability to absorb foreign capital. They used such opportunities to expand exports and imports for industrialisation and development. With manufactured trade, FDI and official development assistance (ODA), these economies were positioned to benefit from the positive impact of OECD-country policies. However, OECD country policy coherence was prominently weak in agricultural policy. During and after the 1997-98 crisis, several ASEAN (Association of South-East Asian Nations) countries, most notably Thailand, rediscovered that the agricultural sector plays an important role in sustaining export earnings and rural household income and absorbing displaced workers, thereby contributing to economic recovery and political stability.

The impact of OECD-member agricultural policies on growth and poverty reduction may differ significantly across developing economies within the region. In the case of commodities, this depends on, among other things, the extent to which the policies in question affect world agricultural commodity prices, the extent to which the domestic agricultural sectors in East Asian economies are linked to those commodity markets and some other structural and institutional characteristics of the economies themselves. For example, the effects of rice and sugar policies in OECD countries on poverty reduction efforts in the East Asian

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

Implications for Other Developing Regions

Drawing lessons from international development episodes is difficult, and the East Asian experience is no exception. All countries and regions are different in essential ways, e.g. in political, legal and economic institutions, economic fundamentals, macroeconomic policy formation and implementation, industrial organisation, characteristics of the factors of production and degree of outward orientation. These characteristics can greatly influence how economic policy gets transmitted or filtered. The subjective historical context in which development takes place also has importance. As noted above, East Asian growth since the early 1970s and particularly the mid-1980s was a function of various positive developments in the international market place, such as favourable exchange-rate and interest-rate changes, copious capital flows in financial markets and technological change that facilitated globalisation and industrial restructuring. A “one-size-fits-all” approach to economic policy formation holds considerable risks. Hence, the first rule in applying lessons is to do so with considerable caution, bearing in mind country-specific circumstances.

Nevertheless, the East Asian experience, although somewhat varied from one country to another, does have some constant features that figure in the success of each country-specific case. After all, there should be reasons why East Asia could prosper over the past few decades, while Latin America and Africa have remained stagnant. Indeed, based on the East Asian experience and in fact that of the OECD area, one can argue that there does exist a set of key economic policy variables underlying economic success:

- The first key variable would be political stability, enabled by functioning security arrangements and ensured through democracy or social consensus.

- Second, macroeconomic stability is key. Contrary to popular belief, the five crisis-affected countries had fairly strong macroeconomic fundamentals on the eve of the 1997-98 financial crisis². Distorted financial market incentives and insufficient institutional development were the main culprits in the crisis.
- Third, in order to benefit from good policies and reforms pursued by OECD countries, such as trade liberalisation, FDI expansion, low interest rates and macroeconomic expansion, developing economies must have in place the policy frameworks and institutional and human capacity to respond.
- Fourth, outward-oriented trade and FDI policies are necessary at least in the medium run. While there is no consensus among economists regarding whether openness is a necessary or sufficient condition during the initial phase of industrialisation, there is consensus that it is necessary (though still not sufficient) in the medium-long term. This reality is clear in the East Asian case as well as from the negative examples of African, Middle Eastern and Latin American countries.
- Fifth, promoting high levels of domestic saving and investment is important in fostering development of efficient financial institutions and generating positive real interest rates.
- Sixth, financial development needs to play a prominent role in any successful economic reform package, but correct sequencing is extremely important, and reform of financial institutions can proceed effectively only if appropriate financial institutions and particularly supervision and monitoring are developed.
- Seventh, governments need to place a strong priority on human-capital development and embrace a clear, gender-neutral approach to education and training.
- Finally, effective governance policies at all levels are critically important to allow economic development to progress.

Challenges Ahead for Policy Coherence in OECD Countries

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

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

There is no need to elaborate how fundamental security and political stability are to long-term growth and poverty reduction in developing economies. A key challenge is to find appropriate instruments to make significant contributions to efforts towards confidence building and conflict prevention in major developing regions. In East Asia, the role of OECD countries in promoting the region's political and security co-operation deserves particular emphasis. The ASEAN Regional Forum (ARF), currently including all ten ASEAN countries, seven OECD member countries (counting the European Union as one) and seven other countries³, has also played an increasingly important part in fostering constructive dialogue and confidence building on political and security issues of common interest and concern.

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

Improving market access for the products and services of major interest to developing-country exporters must be complemented by necessary policy reforms and capacity-building efforts on the part of developing countries, notably the least developed. International assistance can and should play an important, facilitating role in helping them to strengthen domestic supply responses to emerging market opportunities and challenges in an increasingly open trading environment. Trade-related assistance constitutes a salient component of the coherence package OECD countries can offer to make trade work for development (OECD, 2003d).

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

It bears repeating that the reforms necessary to achieve development goals should be home-grown and that such reform efforts can be supported by international aid. East Asia's development experience strongly supports this view. Many East Asian economies made *unilateral* efforts to strengthen productive and trade capacity so as to respond effectively to market opportunities and challenges. The economic ascendancy of the world's two most populous countries, China and India, makes this task even more urgent. Donors have been called upon to help in this regard. On the other hand, East Asian economies have also learned from the events of 1997-98 that it is equally critical to manage financial risk and protect the poor and vulnerable more effectively. This requires governments to strengthen the banking and corporate sectors, while at the same time improving social safety nets and establishing a good working partnership with civil society. Once again, donors have been called upon to assist them. Donors will face a long list of priority sectors for development assistance. This is where aid co-ordination comes into the picture.

Despite the enormous progress of several East Asian economies and more recently China, the circumstances of the region's poorest countries, still highly dependent on a narrow range of commodity or manufactured exports, call for special OECD-country attention. Capacity-building efforts to position their supply side to benefit from globalisation and greater openness in the regional market have high priority. While regional and broader south-south co-operation will likely gain importance in coming years, their dependence on the OECD area for mutually reinforcing, coherent policies will remain significant. For example, a

more strategic use of ODA to help them overcome their unfavourable conditions is warranted. There is an urgent need to strengthen human-resource development through greater investment in education and vocational training for skill upgrading. A focus on agriculture and rural development is also essential to reduce poverty and inequality. At the same time, OECD countries must make further efforts to bring down trade barriers and enhance market access to imports from these developing countries.

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

Revisiting East Asia's Development Process

The development experience of East Asia throughout most of the post-war years is that a number of economies in the region have managed to achieve historically high growth rates of per-capita gross domestic product (GDP) — typically 4 to 6 per cent per annum or even higher in some cases — for a significantly long period. Starting from Japan in the 1950s and 1960s, the region's growth dynamism has continued apace since the 1970s, with the ascendancy of Asian NIEs, followed by several ASEAN economies (Indonesia, Malaysia, the Philippines, Thailand and, most recently, Viet Nam) and China. It should be stressed at the outset that the region's rapid economic growth has been accompanied, with few exceptions, by significant reductions in absolute poverty and noticeable improvements in social conditions, such as life expectancy, infant mortality and literacy.

Most of the literature on East Asia's development experience has focused on the question of how domestic policies and institutions in individual economies were growth-generating (as in the case of the World Bank Report — *The East Asian Miracle* — published in 1993) but did not pay adequate attention to the question of how growth stimuli and incentives were generated and transmitted from more advanced to less advanced economies in a particular region. The effectiveness of growth-promoting policies at the individual economy's level depends critically on how well and how quickly each economy can respond to and exploit the external policy environment and opportunities by means of its own public policies. From this perspective, it is important to take a close look at five issues: *i*) the influence of geography and security; *ii*) multilateral trade liberalisation and "open regionalism"; *iii*) OECD-country macroeconomic and technological vectors; *iv*) the emergence of a trade-FDI nexus; and *v*) the role of international aid.

The Influence of Geography and Security

Geography and security influence development significantly. There is wide recognition that natural and human geography affect the development of a particular country or region through factors such as climate, inherited health and proximity to markets⁴. For instance, countries that find themselves in the tropical zone (mostly developing countries) may have adverse growth prospects compared with those in the temperate zone. The reasons for this include, among others, the long-lasting, negative impact of tropical diseases on education and health and thus on labour productivity, the dominance of extractive industries in national economies and their potentially negative consequences for public institutions

and governance, and low soil quality or plant diseases that may lead to low productivity in agriculture. A study by Gallup *et al.* (2003) examines the influence of geography on per-capita GDP growth⁵. Perhaps their most relevant finding is that geography can explain only a small fraction of the growth gap observed between Latin America and East Asia. Moreover, geographical factors would tend to make East Asia grow slightly *less* fast than Latin America. This would imply that good infrastructure, appropriate policies and well-functioning institutions can help developing countries overcome many of the obstacles imposed by geography.

Security has had a direct bearing on the development of East Asian economies. During the Cold War, maintaining regional security had the utmost importance for economies with strategic alliances with the Western bloc. East Asia has had no region-wide security arrangement in a traditional sense. It has had a combination of US-centred, bilateral security treaties — for Japan, Korea, the Philippines and Thailand — and loose regional forums for security co-operation. The US-centred security treaties are traditional arrangements that oblige signatories to defend their allies if adversaries attack or threaten them militarily. Forums for security co-operation have been developed around ASEAN⁶, including the Treaty of Amity and Co-operation in Southeast Asia (1976) and, more recently, the ASEAN Regional Forum (1994). Security co-operation in East Asia entails multilateral dialogue and information exchange, not only among allies but also with potential adversaries, to deepen mutual understanding and build trust, thereby reducing the probability of military conflict. Domestic political stability, underpinned primarily by the US-centred security arrangements, laid a critical foundation for development. Individual countries then undertook major policy initiatives to promote growth and poverty reduction within the general framework of GATT/WTO.

Multilateral Trade Liberalisation and “Open Regionalism”

Multilateral trade liberalisation under the auspices of the GATT/WTO can be regarded as an institutional foundation underlying East Asia’s clustered, sequential development. One can argue that a gradual opening of OECD markets through the eight rounds of multilateral trade negotiations has been a *sine qua non* for the region’s growth based on outward-oriented industrialisation. China represents perhaps one of the most successful episodes to date. It embarked on the “Reform and Opening-up” policy in late 1978 and moved to embrace the coastal development strategy in the mid-1980s in order to promote trade and attract FDI. Indeed, China’s reforms related closely to the long and often painful accession negotiations at the GATT/WTO, which began in 1986.

Until quite recently, East Asian economies have taken a route different from that of other regions, namely to accelerate trade liberalisation within a trans-regional framework as well as the global framework of the GATT/WTO. Asia-Pacific Economic Co-operation (APEC) was created in 1989 as the first broad intergovernmental forum aiming at closer economic co-operation and partnership involving both developed and developing countries across the Pacific⁷. It was a brainchild of Bob Hawke, then Australian Prime Minister, who coined the term “open regionalism”.

APEC stands out as a unique case of trans-regional integration and co-operation agreements, based on three pillars. First, it has involved non-discriminatory confidence-building measures, such as enhanced exchange of economic information, increased transparency of trade policies among member economies, trade and investment facilitation, consultation, voluntary codes and networking. Second, APEC has sought to design and implement voluntary but common liberalisation programmes. At the Bogor Meeting in 1994, the APEC Economic Leaders announced their intention to pursue “free trade and investment” in the region by 2010 for developed economies and by 2020 for developing economies, based on the principle of *voluntary* unilateral liberalisation. Compared with the habitual incentives for trade negotiations, the APEC route towards free trade and investment among member economies has indeed been a novel approach. If traditional political economy is a guide, however, it would not be realistic to expect concerted unilateral liberalisation to succeed beyond marginal measures because of the free-rider problem under voluntarism and the non-binding nature of policy commitments (Pelkmans and Fukasaku, 1995). Third, APEC has also dedicated itself to technical and development co-operation under the rubric of “ECOTECH”. This pillar began to receive special attention with the 1996 APEC Economic Leaders’ meeting in the Philippines and continues to be a priority, though arguably progress made so far in this area has been less concrete than in other areas.

OECD-Country Macroeconomic and Technological Vectors

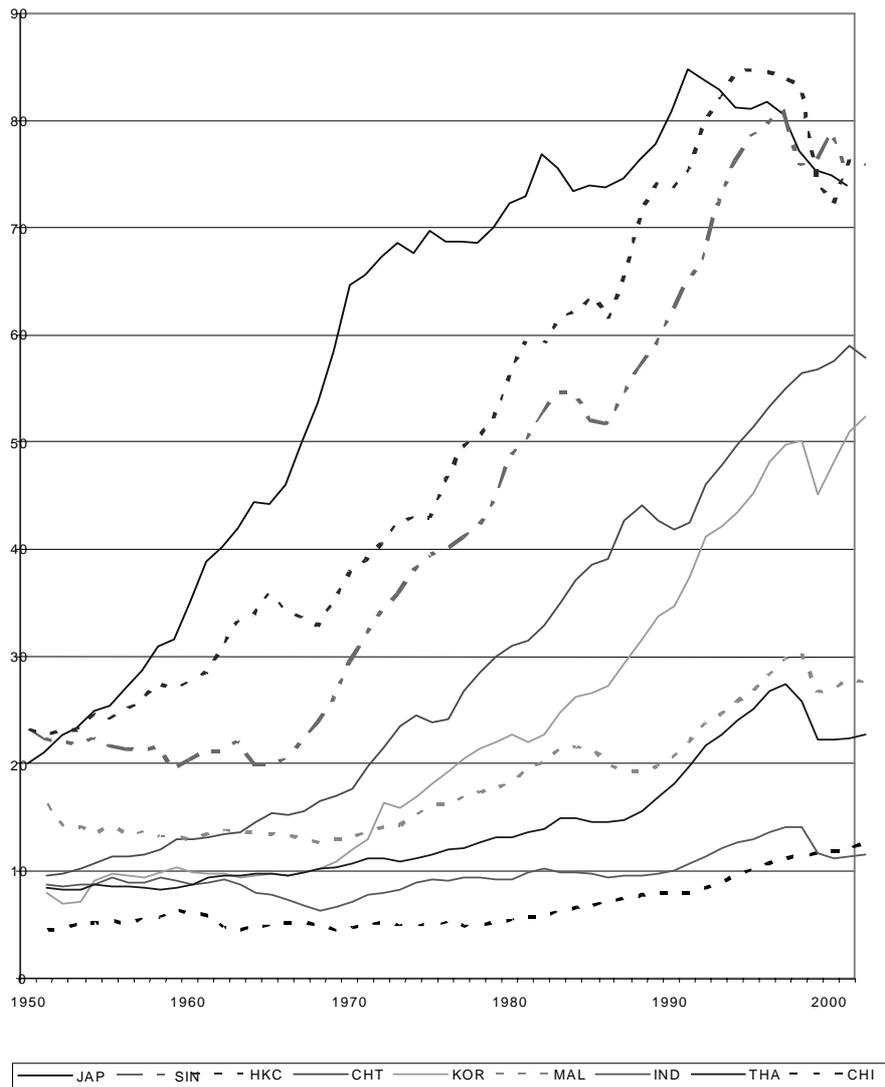
Figure 1 shows that the East Asian economies (except China) simultaneously experienced major economic transformations in the early 1970s and again in the mid-1980s. It would be implausible to consider such coincidence either as random or as deliberate and co-ordinated on the part of governments. The transformation resulted more from significant changes in the international economic environment and less as the consequence of any particular domestic economic policies. Indeed, the 1970s saw sea changes in the international

economic system, with the emergence of strong inflationary expectations in major OECD countries, a breakdown in the Bretton Woods fixed exchange-rate system and the first OPEC oil price shock. In retrospect, adjustment to these developments led to the end of a “golden age of unparalleled prosperity” for Western economies (Maddison, 1995). The Japanese economy had already reached the post-war peak after the “era of rapid economic growth” in the 1960s. Meanwhile, the country had also changed from a labour-surplus to a labour-shortage economy. A significant tightening of labour market conditions, together with successive rounds of the yen’s real appreciation in the 1970s, propelled Japanese firms to invest abroad in, and import more goods from, other East Asian economies. This adjustment process accelerated further in the wake of the Plaza Accord, with the dollar-yen currency realignment that took place in September 1985.

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

These macroeconomic and technological developments emanating from OECD countries and their policies have facilitated East Asian economies’ entry into the network of global production sharing and establishment as viable competitors in world markets. The economic ascendancy of four Asian NIEs during the 1970s has been seen as the harbinger of a promising growth model.

Figure 1. **Real Per Capita GDP for Nine East Asian Economies Relative to United States, 1950-2001**
(percentages of US per capita income, expressed in terms of the 1990 purchasing power parity)



Source: Calculated from Maddison (2003).

The Emergence of a Trade-FDI Nexus

The positive effects of trade and FDI on growth count among the most critical factors underlying the strong East Asian growth performance. The emergence of a “trade-FDI nexus” is a key feature of the region’s outward-oriented growth (Petri, 1995; and Katseli, 1997). Liberalisation of trade and investment policy regimes undertaken unilaterally by many economies in the region has improved the policy environment, favouring the expansion of both trade and FDI flows. Conversely, strong trade and FDI performance has encouraged governments to sustain these outward-oriented policies, thereby integrating their economies more closely into the international market. This positive relationship between liberalisation initiatives and strong trade and FDI growth seems to have worked in East Asia’s favour.

Nonetheless, the role of FDI for East Asia’s clustered, sequential growth has been quite diverse among the economies of the region; some have relied more on FDI than others. For those economies, such as Hong Kong, China; Singapore; Malaysia and, more recently, China and three new members of ASEAN (Cambodia, Lao PDR and Viet Nam), FDI inflows have become increasingly important (see Box for China). This is in sharp contrast with the experience of Japan, Korea and Chinese Taipei in the 1970s and 1980s, as these economies relied much less on “FDI as a package” and more on licensing arrangements as a means of importing foreign technology. It is only quite recently (particularly after the 1997-98 crisis) that the FDI stock-GDP ratio has started to rise markedly in Chinese Taipei and Korea, as these economies have eased restrictions on or taken measures to encourage FDI inflows.

Box. The Trade-FDI Nexus, Chinese Style

Outward orientation differs widely in degree from country to country and period to period. In China, one cannot easily tell precisely how actual policy and the extent of protection in the trade and FDI regimes have evolved. Yet it is safe to say that in the mid-1980s the authorities gave clear signals both at home and abroad that they intended to establish a trade regime in favour of export production. This period also saw China’s *de facto* adoption of the coastal development strategy, an active encouragement of FDI inflows through various schemes of preferential treatment and the beginning of successive real effective devaluation of the Chinese currency (Fukasaku and Wall, 1994).

Box (contd.)

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

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

Trade Performance of Foreign-Invested Enterprises in China

Year	1985	1990	1995	1997	1999	2000	2001	2002
Value of FIE Trade (\$ billion)								
Total Trade	2.4	20.1	109.8	152.6	174.5	236.7	259.1	330.2
Exports	0.3	7.8	46.9	74.9	88.6	119.4	133.2	170.0
Imports	2.1	12.3	62.9	77.7	85.9	117.3	125.8	160.3
Balance	-1.8	-4.5	-16.0	-2.8	2.7	2.2	7.4	9.7
FIE Trade Relative to China’s Total Trade (per cent)								
Total FIE Trade	3.4	17.4	39.1	47.0	48.4	49.9	50.8	53.2
Exports	1.1	12.6	31.5	41.0	45.5	47.9	50.1	52.2
Imports	4.9	23.1	47.7	54.6	51.8	52.1	51.7	54.3

Source: OECD (2002c), Table 10.2, p.327 (for 1985-1999); *China Statistical Yearbook 2003* (for 2000-2002).

FDI inflows into China’s manufacturing sector have been concentrated heavily in the so-called “labour-intensive” industries. Such FDI, however, is not necessarily a poor source of transferable, useful technology and know-how that might help to enhance China’s industrial efficiency. A recent study based on a firm survey of Hong Kong, China garment-sector investing in China has found that FIEs based in Hong Kong, China act as an effective channel for transferring advanced, market-focused managerial know-how and practices to the mainland (Thompson, 2003).

The Role of International Aid

International aid has supported East Asia's post-war development process and in particular the region's emerging trade-FDI nexus, through concessionary financing for economic and social infrastructure construction and technical assistance for human and institutional capacity building. While its precise impact on development cannot be easily measured, East Asia has benefited from the range of official development assistance (ODA) programmes offered by the donors. Several successful cases of ODA programmes, including infrastructure development projects in ASEAN countries, such as the Brantas River Basin Management Project in East Java, have been well documented. International aid can also help the recipient countries, through policy dialogue and consultation, to strengthen their capacity to formulate and implement their own development policies. Again, such impacts are even more difficult to measure, but some anecdotal evidence regarding China's reform experience in the 1980s points to the usefulness of policy dialogue and interaction between the donor community and the recipient country.

This is not to say that international aid in East Asia is free from problems and criticism (McCawley, 1998). On the contrary, international aid has been subjected to a host of public pressures over the last decade. One source of such pressure comes from the increased desire on the part of recipient countries themselves to improve domestic governance in relation to international aid. For instance, criticisms have been levelled at social dislocations and environmental damage caused by large-scale infrastructure projects in some recipient countries. Another concern has been raised over the changing needs of international aid, as the recipient economies develop. Pressures also arise from the domestic front of many donor countries, owing to their budgetary constraints on foreign aid. Although the pressure to cut back aid money appears to have somewhat subdued in the aftermath of the 1997-98 crisis, the fundamental question remains as to what role international aid in East Asia should play in the future. This is particularly important for the reform of ODA policy and management in donor countries, especially Japan (Kawai and Takagi, 2004; and OECD, 2004).

Together with macroeconomic stability and complementary policy reforms aimed at improving local business conditions, the development of economic infrastructure can be seen as a critical requirement for promoting private investment — both domestic and foreign — in the region. ODA has provided an important source of foreign funds to finance it, with relatively stable net flows

averaging on the order of \$6 billion at 2002 prices and exchange rates⁸. This contrasts sharply with fast-rising private flows (mostly direct investment and bank loans) after the mid-1980s (Figure 2)⁹.

Figure 2. Total Resource Flows to East Asia
(Net disbursements at 2002 prices and exchange rates, \$ billion)



Source: OECD/DAC, International Development Statistics (on-line).

There is some evidence that government financing has helped promote Japanese FDI in the region, in line with the country's industrial restructuring and the corresponding need to relocate manufacturing industries losing comparative advantage *vis-à-vis* lower-wage countries. For FDI flows into Indonesia, Thee (1994) highlights an important role played by overseas investment credit — part of other official flows (OOF) — to facilitate Japanese direct investment in manufacturing in the early 1990s. Technical co-operation programmes, such as training local workers and technical consultation for private sector development, also assisted overseas investment activities by Japanese private companies. The Eastern Seaboard Development Plan in Thailand during the 1980s provides yet another example to support the view that the region-wide development of economic infrastructure assisted firms in improving productivity and promoting growth (see JBIC, 2000). More recently, the development community has increasingly recognised the importance of seeking the synergies between ODA and private investment, domestic and foreign. Nonetheless, the volume of net private flows to East Asia dropped abruptly with the onset of the 1997-98 East Asian crisis.

During and after the crisis, interest in ODA revived in East Asia, with a major shift in priorities towards “social infrastructure” (education, health, water and other social services) by all donors, especially Australia, EU member countries and the United States. In value terms, Japan accounted for more than one-third of total ODA commitments for social infrastructure in the region in 1997-2002, although this sector still has relatively modest importance in Japan's ODA.

The East Asian Crisis and Beyond

The East Asian Crisis in 1997-98

The rapid growth of several East Asian economies since the mid-1980s, enhanced by their financial opening and exchange rate pegs, led to large inflows of private capital in the mid-1990s¹⁰. Fuelled by such capital inflows, private credit booms created pre-crisis vulnerabilities in the region. A greater availability of international private funds was considered a good thing for development, potentially welfare-enhancing for recipient countries. Yet greater financial integration made these economies more vulnerable to sudden changes in investor sentiment and the external economic environment, such as international interest-rate shocks. The experience of several East Asian economies in the early 1990s suggests that difficulty in managing large capital inflows was a critical policy issue for macroeconomic management at that time, as these economies were running at near or full capacity (IMF, 1995). Indeed, heavy capital inflows became disruptive for countries such as Thailand, as they led to a real appreciation of the currency, heightened inflationary pressures through increased money supply and widened current-account deficits to an unsustainable level¹¹.

Table I shows major trends in total capital inflows into 24 developing Asian countries, five crisis countries and China for 1994-2002. While the predominant type of capital inflow into China has been direct investment, the five crisis countries had become increasingly dependent on portfolio investment and other (short-term) capital to finance ever-increasing investment demand prior to the crisis. Domestic financial systems proved too weak as conduits for heavy capital inflows, which resulted in over-borrowing and declining credit quality, thereby increasing financial fragility.

The World Bank (1998) summarised the major causes of the 1997-98 crisis. It pointed out three common forces that interacted to leave these economies vulnerable to external shocks: *i)* ready availability of private capital, especially short-term capital; *ii)* macroeconomic and exchange-rate policies that permitted capital inflows to fuel a credit boom; and *iii)* newly liberalised but insufficiently regulated financial systems¹². While the Thai stock market had already declined substantially during the first half of 1997, a trigger to the crisis came when the government yielded to the repeated attacks against the baht and abandoned the peg on 2 July. The Thai financial and currency crisis developed into a region-wide one as contagion spread to Indonesia, Malaysia, the Philippines, Korea and other economies by causing a sudden, huge outflow of capital and a simultaneous fall in asset prices.

In addition to the associated detrimental social effects, the 1997-98 crisis dealt a heavy blow to the economies of the region in the fiscal cost of bailing out and reconstructing the financial sector and the output forgone as a result of the historically worst-ever recession that ensued. Moreover, some concern arose that the social impact of the crisis might have a lasting economic effect over the longer term. Such concern has drawn greater attention to the question of social cohesion and domestic governance in East Asian societies.

Table I. **Net Capital Inflows in Developing Asia**
(\$ billion)

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

Notes:

a) 24 economies in Asia and the Pacific, including Korea and Singapore but excluding Chinese Taipei.

b) A minus sign indicates an increase.

c) Indonesia, Korea, Malaysia, the Philippines and Thailand.

Sources: IMF, *International Financial Statistics* (CD-ROM) and OECD/DAC, *International Development Statistics* (on-line).

Lessons from the Financial Crisis

The three major lessons to draw from the financial crisis all relate to policy. They stress the importance of:

- managing financial globalisation;
- improving national economic structures and foundations; and
- strengthening social protection.

Managing Financial Globalisation. The successive financial and currency crises of the 1990s have led the international financial community to realise that they resulted not only from specific (and often idiosyncratic) factors in particular countries, but also from some common trends inherent in today's international financial system. The risks involved in large flows of short-term capital and their sudden reversals are now widely recognised. It is therefore necessary for host economies to put their own financial houses in order, so as to reap the benefits of financial globalisation without falling victim to its associated risks. Major reforms are required at all levels, global, regional and national.

At the global level, active discussions on policy initiatives to strengthen the international financial architecture had begun soon after the Mexican peso crisis in December 1994. The East Asian crises gave further impetus to them and to agenda setting (Eichengreen, 1999; Kenen, 2001). In June 1999, at the G7 Summit Meeting in Cologne, the Report of G7 Finance Ministers made a six-point, comprehensive set of recommendations to promote global financial stability through appropriate national actions and enhanced international co-operation¹³:

- strengthening and reforming the international financial institutions (notably the IMF) and arrangements;
- enhancing transparency and promoting best practices (in various areas, including disclosure of financial data, transparency in fiscal and monetary policies, corporate governance and so on);
- strengthening financial regulation in industrial countries (particularly for the operation of highly leveraged institutions and offshore financial centres);
- strengthening macroeconomic policies and financial systems in emerging economies;
- improving crisis prevention and management, and involving the private sector; and
- promoting social policies to protect the poor and most vulnerable.

Over the past five years a number of reform proposals have emerged to reduce the severity and frequency of future crises. They are admittedly “modest and incrementalist, rather than sweeping and revolutionary — perhaps more like redoing the plumbing and electricity in the house than redesigning the architecture from the ground up” (Frankel and Roubini, 2003, p. 272). Yet the crisis has played a strong catalytic role in advancing reforms in all the countries it struck. To restore investor confidence and better manage financial globalisation, prudential supervision and regulation in the banking sector have been strengthened, together with restructuring of the financial and corporate sectors. Indonesia and Thailand, for example, have made significant legislative changes in their bankruptcy procedures. Another prominent area of reform has involved further liberalisation and deregulation of foreign investment in nearly all countries in the region.

Meanwhile, three particular areas have seen efforts to promote regional monetary and financial co-operation: enhancing information exchange and surveillance, improving resource provision and promoting the Asian bond market. For the first, the Manila Framework Group established in November 1997 brings together deputies from the finance ministries and central banks of 14 countries within and outside East Asia, together with the IMF, World Bank, ADB and BIS. Furthermore, the ASEAN+3 (China, Japan and Korea) surveillance process was established in November 1999 and its first peer review meeting held in May 2000. In the second area, the Chiang Mai Initiative launched in May 2001 has two parts: an expanded ASEAN Swap Arrangement and a network of bilateral swap and repurchase agreements among ASEAN+3 countries (Kuroda and Kawai, 2002)¹⁴. The third area has received greater attention more recently, in the development of deeper and more liquid local currency-denominated bond markets, which can produce a more balanced regional financial system and facilitate more efficient allocation of the large pool of domestic savings, thus reducing the “double mismatch” problem. ASEAN countries are also exploring the possibility of improving cross-border bond issuance.

National Efforts to Strengthen Economic Policies and Institutions. As recommended in the Cologne Report of G7 Finance Ministers, individual developing economies have made efforts to strengthen policy and institutional frameworks with an emphasis on macroeconomic management capacity and financial-sector reform. Attention has focused particularly on the need to improve regulation and supervision in the financial sector, to strengthen corporate governance and to establish effective domestic insolvency procedures to deal with non-viable banks and corporations. With stronger domestic underpinnings in these areas, crises should become less likely to occur and, even if they do arise, their impact on the economy will tend to be limited.

One of the principal instruments for strengthening domestic policies and institutions is international best-practice information on macroeconomic policy making, financial regulation and supervision and capital-market infrastructure. Reports on the Observance of Standards and Codes cover 12 issues in these three areas. Macroeconomic policy includes monetary and financial policy transparency, fiscal transparency and special data-dissemination standards in addition to the general data-dissemination system. Financial regulation and supervision include banking supervision, securities regulation, insurance supervision, payments systems and countering money laundering. Capital market infrastructure includes corporate governance, accounting standards, auditing standards and insolvency and creditor rights. These processes are undoubtedly useful, but take time for effective implementation.

Five sets of corporate governance issues can serve to illustrate the linkages to public policy in East Asia. First, group affiliation is the most frequent organisational form, by which several firms, often family controlled, link through complex ownership structures. Some such groups may suffer from resource misallocation and mismanagement. Second, the high diversification of firms does not help them to weather turbulent times favourably, contrary to expectations. Third, financial disclosure and transparency tend to be low, although earnings information is better in foreign-held firms. Fourth, a review of issues related to the financial crisis indicates that relation-based financial systems may result in the misallocation of capital in the face of external shocks. Finally, firms' financing structures and relationship banking raise further corporate governance issues, such as high debt-asset ratios and less effective use of recourse to bankruptcy (Claessens and Fan, 2002). Links between corporate and public governance thus exist in terms not only of ownership patterns, but also of competition policy and the regulatory framework in which firms operate. The quality of public governance also affects corporate life through governments' and politicians' tolerance for collusion, rent seeking and corruption as well as the extent of rule enforcement (Oman and Blume, 2005).

Social Protection. East Asian countries have made great strides in alleviating extreme poverty (measured by the lower international poverty line) over the last ten years or so. The 1997-98 crisis arrested and temporarily reversed this overall trend and made one thing clear to every citizen in East Asia: informal, family-based mechanisms on which traditional societies relied as the main form of social protection have been revealed as inadequate to cope with nation-wide shocks that could bring down large numbers of households simultaneously. Evidence thus far indicates that the social impact of the crisis was substantial, but more importantly, the impact on poverty was much less severe in some countries than

in others. Some of the less affected economies could absorb workers displaced from the formal industrial sector in agricultural and (informal) service employment — in other words, much of the adjustment took the form of lower real wages. In Malaysia migrant workers bore the brunt of adjustment more than domestic ones did (World Bank, 2000, p. 117). In Thailand, agricultural exports received a positive boost from real currency devaluation, which contributed to supporting rural household income.

The crisis underscored an urgent need to establish more formal mechanisms for managing risk and protecting the poor and socially vulnerable. The decline of *relative* poverty (measured by the upper international poverty line) has been much slower than that of extreme poverty. Four years after the crisis, the proportion of the “near-poor” remained very high in Indonesia (58 per cent) and the Philippines (43 per cent), followed by Thailand (27 per cent). All five crisis countries have undertaken initiatives to adapt existing institutions to evolving social conditions and to establish new ones (see OECD, 2002a).

A number of proposals have been put forward to improve the design and implementation of social protection — particularly for social assistance, social insurance, employment and community-based schemes. First, under-coverage is recognised as a serious drawback in social protection regimes. Workers in the informal sector as well as in rural areas, frequently women, constitute the majority of the workforce most vulnerable and often excluded from public social services. Second, the design and choice of targeting mechanisms require further study, taking into account individual countries’ particular situations. Trade-offs are evident in terms of economic incentives, fiscal objectives and political acceptability. Third, involvement of civil society in programme implementation and monitoring is essential to enhance the efficiency and coverage of social protection policy.

Agendas beyond the Crisis

There is a case for rethinking the basic approach to the sustainability of East Asia’s economic growth and development from several fundamental perspectives. Many East Asian economies have in common two longer-term policy challenges that deserve much more serious attention in coming years. One is the *demographic challenge* to the health of public finance as a consequence of rapidly ageing societies, and the other is the *globalisation challenge* of coping with issues related to greater labour mobility across borders, technological capability development

and trans-border environmental spillovers. To meet these new challenges, East Asian societies need to take forward-looking, more coherent approaches, several of which are discussed below.

Regional Trading Arrangements. Prior to 2002, the only formal regional trade arrangement in East Asia was the ASEAN Free Trade Area (AFTA), which was established in 1992. Following its establishment in 1967, ASEAN countries began joint efforts to promote intra-regional trade and economic co-operation among themselves¹⁵. Despite the slow pace of trade liberalisation, AFTA has been in effect among the original five ASEAN members (Indonesia, Malaysia, the Philippines, Singapore and Thailand) and Brunei Darussalam since January 2002. Although the exclusion list is long and individual country circumstances vary, the bulk of goods traded between these countries now bear tariffs of only 0-5 per cent. Viet Nam will comply with the same tariff standards by 2006, Laos and Myanmar by 2008 and Cambodia by 2010. ASEAN as a whole is expected to become a tariff-free FTA by 2010 for the six members and by 2015 for the new members. At their Summit meeting in Bali on 7 October 2003, ASEAN leaders agreed to the creation by 2020 of an ASEAN Community, comprising three pillars, namely political and security co-operation (an ASEAN Security Community), economic co-operation (an ASEAN Economic Community) and socio-cultural co-operation (an ASEAN Socio-Cultural Community). These three pillars are mutually reinforcing to ensure security, shared prosperity and social stability in the region, within which there would be free flows of goods, services, investment and skilled labour.

Recently, East Asia has begun to embrace North-South FTAs as a means to accelerate market opening and structural reform to sustain growth momentum within the region. As many of the region's economies recover from the 1997-98 crisis, external pressures that FTAs would generate are considered necessary to liberalise trade and FDI further and to deepen structural reforms in pursuit of regained and sustained economic growth. The East Asian economies also consider FTAs as an integral component of broader economic partnership agreements that include, *inter alia*, trade and FDI facilitation, harmonisation of standards, rules and procedures and economic co-operation in many areas.

Table 2 presents a list of the FTAs involving East Asian economies that are already in action, concluded, under negotiation or under study. This FTA bandwagon may reflect a fundamental change in the attitude of many East Asian governments towards market-driven economic integration and the institutionalisation of such integration.

Table 2. Free Trade Agreements and East Asian Economies (end-September 2004)

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

Sources: Compiled on the basis of official sources.

It is often pointed out that an East Asia-wide FTA would be economically desirable¹⁶. Yet current initiatives to establish FTAs involving China, Japan and Korea on the one hand and ASEAN, either as a group or individually, on the other might eventually produce an East Asia with competing trade arrangements. To avoid this “spaghetti bowl” effect and to maximise potential benefits, the regional economies need to draft a clear road map to establish a region-wide FTA in East Asia. Regional trade arrangements that ensure greater coherence of trade, FDI and aid policies need to be created to promote the region’s growth and development.

Labour Migration. The pattern of labour migration seems to have complemented the region’s multi-layered, sequential industrialisation and market integration based on increased trade and investment linkages. China, Indonesia and the Philippines are predominantly migrant-sending economies, while Chinese Taipei, Japan and Korea are on the receiving side, although their stocks of foreign labour remain small in relative terms. Some middle-income economies, such as Thailand and Malaysia, have made a transition from net emigration to net immigration, reflecting the co-existence of unskilled immigrants and highly skilled emigrants. The basic policy approach taken by Japan and other receiving economies is to promote job creation in less advanced economies in the region and relocate their uncompetitive manufacturing operations to them, in order to control the inflow of unskilled foreign workers.

Migrant remittances play an important role in supporting the living standards of some East Asian sending countries, notably the Philippines where remittances accounted for over 9 per cent of GDP in 2002. The international business networks established by emigrants also provide an additional source of capital flows into the home countries. For instance, investments from entrepreneurial emigrants, together with their diaspora networks, have played a critical role in the recent rapid growth of ICT-related industries and service sectors in China and India.

Highly skilled migrants within the region are mostly company transferees who are frequently shifted within multinational enterprises¹⁷. This type of labour migration tends to accompany FDI in the more advanced productive sectors, and it contributes to technology transfer and human resource development in host economies. The notion of “brain exchange” or “brain circulation”, as opposed to “brain drain”, may better capture the real nature of the regional movement of high-skilled workers. Within the vision of an East Asian Community noted above, migration policy needs firmer embedding in a coherent policy of regional integration and development.

Technological Capability Development. Recent OECD work on the sources of economic growth (OECD, 2003b) confirms that fundamental macroeconomic and structural policy prescriptions for sustainable, long-term growth remain valid. Nonetheless, access to and effective use of information and communications technology (ICT) as well as the type and quality of education have driven growth in a number of countries. Not only does this imply the need for better youth education, including the integration of ICT into curricula, but also more adult, life-long learning, including an improved distribution of vocational training across different categories of workers. Pro-competitive regulations that facilitate the entry of innovative firms are also important growth drivers. Analysts of the current East Asian situation point to the need to tap better into knowledge and R&D and to upgrade human resources, as well as to increase competition between firms (Chen, 2003, Pai *et al.*, 2003 and Yusuf, 2003).

China’s ascendancy and its impact on East Asia intensify the competitive pressures for industrial upgrading in these economies. Policy makers are concerned about the changing shares and composition of trade, as well as shifts in investment flows toward China and away from their economies. China’s imports and China’s FDI-induced trade are seen to benefit mainly developed countries (Chen, 2003), while areas of trade overlap are greatest with neighbouring economies. As labour costs increased in the Asian NIEs and ASEAN by the mid-1990s, Japanese investment gradually shifted to China (Abe, 2003). Thus, countries like Malaysia will have to depend less on labour-intensive, low-wage manufacturing than

before (Yusof, 2003). Simulations have shown that additional welfare losses in ASEAN-4 will occur only if they fail to improve their capacities to absorb new foreign technologies and to engage in home-grown technical innovations (McKibbin and Woo, 2003). The sheer size and rapid rise of China imply that other East Asian economies will face major industrial adjustment and restructuring. At the same time, they will also see new opportunities in terms of growth stimuli and incentives, which might be comparable to those presented by the rise of Japan and the Asian NIEs during earlier decades¹⁸.

Governance. Most facets of national public governance equate with institutional development. Good governance may be regarded as a package of “good institutions” that frequently includes democracy; a clean and efficient bureaucracy and judiciary; strong protection of private property rights, including intellectual property rights; good corporate governance frameworks, especially disclosure requirements and bankruptcy law; and well-functioning financial systems (Chang, 2002). Applying the analytical framework of a “relation-based” system of governance as practised in East Asia compared with the “rule-based” version predominant in the West reveals that the governance package is poorly developed or lacking in the *guanxi* (relations or connections)-based system (Li and Park, 2003). This gap in the institutional infrastructure of East Asia has received greater attention in the aftermath of the crisis; the previous sub-section discussed some of the changes underway. The question is whether attitudes and behaviours are changing in favour of implementing and not just creating a rule-based paradigm.

Movement towards good public governance requires the participation of citizens, including women, supported by strong civil-society institutions to hold government accountable and monitor performance. At the corporate level, there is an analogous need to protect minority shareholders and investors. The technological means to facilitate the normal transition from relation-based to rule-based governance exist in information and communications technologies. East Asian countries can draw on good practice from other developed countries. The pressures of closer economic linkages with these countries and of globalisation more broadly will further encourage the transition, as the costs of maintaining the relation-based system become too high (Li and Park, 2003). Nonetheless, the necessary institutions take time to function properly, which calls for long-term commitment and investment.

The OECD countries’ coherent, mutually reinforcing contribution to good governance consists in helping to strengthen policy frameworks and institutional fundamentals through policy consultation, promoting transparency and transferring good practices (OECD, 2002b). Demonstration effects based on

good governance standards and instruments, including regulatory and supervisory frameworks, can be useful points of reference. To minimise incoherent policies and practices, OECD countries should continuously strengthen their own application and enforcement of anti-bribery and anti-corruption measures, the international investment instruments, and the *Guidelines for Multinational Enterprises*, as well as widen the number of East Asian countries that adhere to these instruments. Peer review can maintain good standards of behaviour and exchanges of practices and experience.

Environment. Developed countries have been responsible for most of the environmental damage to the planet, and OECD countries have the most financial and institutional capacity to address the consequences. Yet environmental pressures will be generated to an increasing extent by developing countries, which also need to become more fully engaged in preventing and mitigating their impacts. The East Asia region currently faces a host of serious environmental problems and challenges. They include especially (Davis, 2003; ADB, 2001):

- extensive land and soil degradation and severe deforestation, further menaced by more intensive agricultural practices;
- water shortages and pollution, air pollution, solid and hazardous waste generation that will increase with rapid and unplanned urbanisation and the growth of mega-cities;
- unsustainable use of non-renewable energy;
- over-fishing as well as marine and coastal pollution;
- acid rain, ozone-depleting chemical production and greenhouse gases; and
- threats to the biodiversity of one of the world's most richly endowed areas.

The combination of current and mounting problems threatens the health, well-being and security of the population, especially the poorest. Even if East Asian countries are aware of the increasing dangers to the environment created by their rapid industrialisation and economic growth, income levels will constrain the willingness and ability of their populations to address them. Provision of information, transparency and participation of civil society in decision making will be necessary to generate political support for the actions required.

Many of the environmental problems involve spillover effects and implicate more than one country. Co-operation, improved governance quality and policy integration at the regional level must be part of future strategies. The importance of adopting integrated river-basin management not only for national but also for

trans-boundary water resources provides one illustration. Other examples include air pollution and dwindling fisheries resources as well as issues of climate change and biodiversity, which are of even wider, global concern (OECD, 2002d). OECD countries — including Asian members — have made significant progress in addressing environmental problems, although much remains to be done. They have gained considerable experience in developing environmental policies, applying policy instruments and generating technological solutions for environmental problems. The efficient process of technology transfer that has contributed to East Asia's rapid growth could be part of the solution in addressing the serious environmental challenges that threaten sustainable development in the region.

Rural Sector Development. Despite the remarkable reduction in the numbers of poor people, poverty remains predominantly rural in East Asia and will continue to pose a difficult challenge. The disproportionate concentration of the poor in rural areas accounts for 80 per cent to 90 per cent of poverty in all the major countries of the region (IFAD, 2002). According to FAO projections (*World Agriculture towards 2015/2030*, Rome 2002), the number of undernourished people in East Asia will still amount to some 140 million in 2015, and poverty is likely to persist in parallel. Among those most likely to suffer from rural poverty are the landless, marginal farmers and tenants, women and female-headed households, indigenous peoples, ethnic minorities and forest and upland dwellers, as well as internally displaced persons and victims of landmines. Rural poverty links closely with environmental problems, especially in areas at the margins of forest land.

It is important to differentiate between patterns of rural and agricultural development in the Northeast Asian economies of Chinese Taipei, Korea and Japan and those in ASEAN countries. Because of their differing stages in the sequential pattern of development, countries in Southeast Asia have created fewer productive non-agricultural employment opportunities in their rural areas. Agriculture is the primary source of employment for over 40 per cent of the labour force in all Southeast Asian countries (except Brunei, Malaysia and Singapore) and for more than 80 per cent in some, like Lao PDR (Booth, 2002; World Bank, 2001). None of them has yet reached Korea's 1977 departure point, when agriculture's share of employment was at 40 per cent before dropping to 16 per cent within 14 years (Kim and Lee, 2003). The situation calls for a renewed focus on equitable land reform, productivity gains, off-farm employment and economic, social and institutional infrastructure adapted to today's conditions. Low and sometimes declining public expenditures in agriculture will need reversal.

For several economies in the region, including the Northeast, structural adjustment measures could help transform a lagging, traditional agricultural sector into a more competitive and economically viable one. Enhanced competitiveness implies economies of scale; higher standards, quality and food safety; better packaging and delivery; developing brand names and niche products; removing restrictions and protection; and more research and development. Developing the food industry would generate employment, add value, increase exports and provide a gateway to new economic activities related to biology, life sciences, etc. It may also help reduce regional disparities, because the hubs for the food industry could be different from those of other industries and could provide employment opportunities to poor segments of the population. Any strategy of exporting high value-added products, however, faces the two-pronged challenge of increasing competition from China and of tariff escalation and non-tariff measures in potentially importing OECD countries. The OECD area needs greater attention to policy coherence by reducing escalating tariffs that discriminate against value-added products and by ensuring that non-tariff measures are not used to reduce developing-country access to OECD markets.

International Aid. While there remain diverging views among donors on how aid *should* work, aid has served, from the East Asian economies' point of view, as a useful vehicle to facilitate human resource development, improve both hard and soft infrastructure, promote SME development and create various institutions for industrialisation. Emphasis among these priorities differs across recipients and over time. From the beginning of the 21st century, it appears that the pendulum has swung back towards economic infrastructure. Owing to the limited investment in it during the crisis and post-crisis period, many developing economies that have resumed growth have found their industrial overhead capital increasingly inadequate. Thus they have started to focus on economic infrastructure development once again, but this time by positioning its role within well designed sectoral programmes and overall development policies, by paying full attention to the social and environmental implications and by maintaining the right balance with social infrastructure building. The donor community must therefore come up with a viable menu of modalities and areas of development assistance in which individual donors can specialise based on their comparative advantages. To make such a menu approach coherent, better and more effective co-ordination among donors becomes even more important.

Building on technical work by the DAC and multilateral development banks, the international development community has committed to deliver and manage aid more effectively to increase development impact. The commitment is part of the Monterrey Consensus (2002) and is set out in the Rome Declaration on

Harmonisation (February 2003), followed up and strengthened in the Paris Declaration on Aid Effectiveness (March 2005). Simplification and harmonisation of donor systems, procedures and requirements and reduction of their costs lie at the core of this undertaking. An ambitious programme of work agreed in Rome has a central focus on implementation at country level, emphasising country ownership and government leadership, capacity building and diverse aid modalities. Bilateral and multilateral donors and partner countries, including Cambodia and Viet Nam, co-operate in the DAC Working Party on Aid Effectiveness and Donor Practices to demonstrate that aid and expected increased volumes of aid can be managed effectively and coherently. The challenge is to turn examples of good practice into generalised practice on the ground. Indicators of progress were agreed in Paris, with measurable targets to be adopted by the September 2005 UN Summit.

The Dynamics for Another Miracle

In retrospect, what was the East Asian crisis, when viewed from the perspective of the region's clustered, sequential development process? Was it a temporary aberration in the long-term growth trend or something more fundamental? Is the coherence of OECD policies a relevant issue for the future?

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

In considering whether East Asia can achieve another miracle of growth over a sustained period, at least three issues come to the fore. The first involves the design of domestic policies and institutions to ensure that the benefits of economic growth become more broadly and equitably shared within society. Although many East Asian economies successfully alleviated extreme poverty over the past decades, it has proved more difficult to reduce income inequality.

Designing effective social protection presents a major challenge for this purpose, and the experience of relatively advanced economies of the region (e.g. Chinese Taipei and Korea) may provide useful lessons.

Second, FDI flows into ASEAN have slowed in recent years, relative to those into China. Middle-income ASEAN countries — Malaysia, Thailand, Indonesia and the Philippines — now face the major challenge of improving their attractiveness as hosts to FDI in a rapidly changing economic environment¹⁹. To remain attractive and competitive, the ASEAN economies must maintain FDI-friendly climates, continue to upgrade human capital and move on to a technological rather than a factor-intensive mode of production by shifting to knowledge-based economies. They also need to implement the AFTA by eliminating their often-long exclusion lists in order to enjoy a larger market and economies of scale.

Third, several low-income countries — such as Cambodia, Lao PDR and Myanmar — have been left behind and are less successful in participating in the region's multi-layered, sequential development process. Institution building for economic development and progressive poverty elimination in these countries should have the highest priority. An important policy question concerns how ODA programmes can be linked more directly to trade and FDI through their emphasis on promoting infrastructure development. One of the key lessons from East Asia's sequential development is that Japan and other advanced economies have regarded outward FDI to the less advanced economies of the region as part of the industrial restructuring necessary to move up technological ladders and shift domestic resources to more efficient uses. Now, the roles of not only these advanced economies but also middle-income countries are becoming increasingly important to keep this dynamic process moving.

Notes

1. See House of Commons (2004) on this point.
2. Indonesia, Korea, Malaysia, Philippines and Thailand (see Section on *The East Asian Crisis and Beyond* for further details).
3. China, India, Korea DPR, Mongolia, Pakistan, Papua New Guinea and Russian Federation.
4. Note that the influence of geography on development has historical and cultural dimensions as well. Countries tend to interact closely with their neighbours both in history (alas, often in wars and conflicts) and through cultural exchanges, which has important ramifications for economic development.
5. Their results do lend support to the view that health conditions related to geography may be a major obstacle to long-term growth. Other things equal, countries at high risk of malaria tend to grow more slowly than countries free from malaria by 0.6 percentage points, which is large relative to other explanatory variables.
6. ASEAN itself was created in 1967 to deal mainly with political fears originating from instability in Indochina and in mainland China at the time.
7. The 12 original members of APEC are six ASEAN countries (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand), five OECD countries (Australia, Canada, Japan, New Zealand and the United States) and Korea (which became an OECD member in 1996). The current 21 member economies of APEC include Chile; China; Chinese Taipei; Hong Kong, China; Mexico; Papua New Guinea; Peru; Russia and Viet Nam, in addition to the original 12.
8. In comparison with ODA, total official flows, including OOF, have been less stable in more recent years, owing to large emergency loans to the crisis countries in 1997-98 and loan repayments in the subsequent years. In 2002, the total amount of official flows (ODA plus OOF) to East Asia turned negative, because of large loan repayments.
9. The data used for this figure were extracted from OECD, *International Development Statistics Online*. The official flow data are expressed both at current prices and exchange rates and at 2002 constant prices and exchange rates. The deflators for official flows were used to convert private flows at current prices and exchange rates into the volume data. Private flows include direct investment and bank loans as well as grants by NGOs. Note that “East Asia” here excludes Myanmar.
10. It has been argued that falling US interest rates in the early 1990s were an important “push” factor in driving private capital to emerging economies (Fernández-Arias and Montiel, 1996).

11. In Thailand, for example, the current-account deficit in 1996 amounted to -7.9 per cent of GDP. The size of a “sustainable” deficit is difficult to determine *a priori* and depends crucially on the perceptions of investors, which may be influenced by a country’s stage of development, its government deficit, the way funds are spent and so on.
12. There is now a large body of literature on the causes of the East Asian crisis. Interested readers should see, among others, Montes (1998); Radelet and Sachs (1998); Reisen (1999); and Woo *et al.* (2000).
13. Before the Cologne Summit, the new Financial Stability Forum was created in April to enhance international co-operation and co-ordination in financial market supervision and surveillance (see <http://www.fsforum.org>).
14. The total number of bilateral swap agreements has reached 16 and the total size of these arrangements amounts to \$36.5 billion excluding the arrangements under the New Miyazawa Initiative, and \$44 billion including the NMI (see Kawai, 2004).
15. These efforts included, among others, the ASEAN Industrial Project (1976), the ASEAN Preferential Trade Arrangement (1977), the ASEAN Industrial Complementation Scheme (1981), the ASEAN Industrial Joint Venture Scheme (1983) and the ASEAN Free Trade Agreement (AFTA). In AFTA, the Common Effective Preferential Tariff (CEPT) Scheme is used to reduce tariffs within the region to 0-5 per cent. The ASEAN Industrial Cooperation Scheme (AICO) applies the CEPT tariff rates (0-5 per cent) on approved AICO products to strengthen industrial co-operation within the region. AFTA is complemented by the Framework Agreement on the ASEAN Investment Area (AIA), which promotes free investment and movements of skilled workers, professionals and technologies within the region.
16. See, for example, Scollay and Gilbert (2001, 2003), Cheong (2003) and Urata (2004). More generally, the question of how regionalism may or may not contribute to development has been under intensive discussion. See, for example, Kreinin and Plummer (2002) for a critical review of this topic.
17. A “highly-skilled” worker is generally defined in terms of educational background, official professional qualification, working experience or some combination of these factors. In practice, however, this definitional question poses a number of practical problems, which makes an international comparison very difficult, since there are many different types of “high-skilled” workers in different countries. See OECD (2003a) for further discussion.
18. See Reisen *et al.* (2005) for further discussions on new issues of interdependence in macroeconomic policy.
19. A recent study by McKibbin and Woo (2003) regarding the global economic impact of China’s accession to the WTO suggests the possibility of de-industrialisation in ASEAN-4 economies if they allow the drop in FDI inflows to reduce the rate of technological diffusion to them. The authors argue that ASEAN-4 economies must give the highest priority to deepening and widening their pool of human capital by speeding up the diffusion of new knowledge to their scientists and managers and providing appropriate retraining programmes for displaced workers.

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Coherence issues drawn from specific country and regional cases can provide the most concrete information on the development implications of OECD-country policies. A first regional case study focused on East Asia, with financial support from the Policy Research Institute of the Japanese Ministry of Finance. The links between the region's developing and transition economies and major OECD countries are strong, not only through the international exchange of goods and services but also through international flows of capital, technology and labour. The East Asian region is, therefore, of particular interest from the standpoint of the development impact of OECD-country policies. A central question involves how different policy vectors transmitted by OECD countries, notably in trade, investment and aid, may or may not have contributed to the region's progress. The intensity of such policy impacts has also depended critically on the capacity of East Asian economies to respond through their own public policies. This *Brief* sketches out the main story lines of what has happened to East Asia over the past decades, particularly since the mid-1980s, through the lens of OECD countries' "policy coherence for development". It also discusses key policy agendas for the region, draws lessons for other developing regions and identifies major challenges ahead for policy coherence in OECD countries.

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