



GLOBALISATION

Keeping the Gains



DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

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Initially called the East Asia Analytical Unit, the Economic Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia and other emerging markets. In 1999, the Unit's research scope was expanded to include important emerging market issues outside East Asia, so in November 2001, it was renamed the Economic Analytical Unit. Part of the Department of Foreign Affairs and Trade, to date the EAU has released 30 reports on major issues related to Australia's trade and investment policy interests.

Staffed with seven professionals, the EAU also contracts a range of consultants with specific areas of expertise. It draws on a wide range of data and information sources, including Australia's diplomatic and trade missions around the world.

The Unit produces reports and briefing papers intended to assist analysts and decision makers in business, the Australian Government and the academic community.

Full copies of previous reports and executive summaries now can be downloaded from the Internet. See website details below.

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EXECUTIVE SUMMARY

GLOBALISATION WORKS

The experience of Australia and many of its successful East Asian neighbours shows globalising economies, those that are open to international trade and investment, deliver their populations higher growth in per capita incomes and better living standards than those that remain closed to the world. In the 1980s and 1990s, developing countries that increased their exposure to international trade grew about four times faster than those that did not. Over this period, the faster income growth of globalising economies reduced the number of people in the world living in poverty by about 200 million, even though poverty increased in more closed economies, especially in Africa, and the world's population grew by about 2 billion.

Globalising economies typically enjoy rising wages and environmental standards; they are not involved in a so-called 'race to the bottom'. Exporting labour intensive industrial and agricultural products has proved the fastest way to expand productive employment opportunities and raise incomes for millions of low skilled, asset poor workers in developing countries. Openness to the world economy, functioning markets and sound regulatory settings also can improve developing and developed countries' environmental standards. Globalising economies are better placed to acquire environmentally friendly technologies and knowledge and move into industries and services that place less demand on scarce environmental resources like clean air and water.

DOMESTIC POLICIES MATTER MORE THAN EVER

Far from weakening governments' influence, globalisation makes it even more vital that governments develop sound domestic policies and institutions so citizens and corporations can prosper in open markets. To export successfully, local firms, investors and workers must be able to respond flexibly to market derived prices so exporters can specialise in areas in which they are internationally competitive. To attract and prosper from foreign and local investment, economies need to guarantee property rights and provide efficient capital markets governed by effective, accountable and enforceable regulatory regimes. To be successful, globalising economy governments also must provide efficient infrastructure services; and to reap the benefits of new technologies, societies that seek to globalise require well educated work forces, credible intellectual property rights protection and access to venture capital. Governments also play an important role in reducing entrenched inequality and spreading the gains from globalisation by providing all citizens access to basic education and supplying at least some social safety nets.

GETTING INTERNATIONAL POLICIES RIGHT

International trade barriers can prevent developing countries taking the first steps towards export-oriented growth. Developed country trade barriers and production subsidies cost developing countries more than current aid flows benefit them and impose significant costs on their own consumers and producers using imported goods and services. High trade barriers against developing countries' agricultural products and labour intensive manufactures and developed country agricultural subsidies of around US\$1 billion per day shrink markets and lower prices for developing country farmers and also damage efficient developed country agricultural producers.

The World Trade Organization's Doha Round of trade liberalisation negotiations, the so called Development Round, has as one of its central aims increasing developing countries' access to developed country markets and addressing other trade related issues concerning developing countries, as well as expanding markets for efficient agricultural exporters like Australia.

As the world integrates further, the international community is under increasing pressure to provide solutions to a wide range of other global problems. These include ensuring international capital markets function efficiently and addressing effectively trans-nationality issues ranging from terrorism to containing the spread of communicable diseases.

AUSTRALIA'S GLOBALISATION EXPERIENCE

Australia's experience shows how a medium sized open economy with appropriate domestic policies and strong institutions can succeed in a more integrated and competitive global economy. Over the past two decades, Australian governments have cut tariffs, opened capital markets to international flows and promoted competition. By 2002, Australia enjoyed one of the world's most open trading and investing environments. Over time, these reforms transformed Australian industries and service sectors, encouraging them to adopt new technologies, increase training efforts and seek export markets. Successive governments also increased the transparency and accountability of important economic governance institutions, enabling Australia to respond effectively to the demands of a globally integrated economy.

Opening to world markets also increased pressure for other domestic reforms, including in labour and capital markets, taxation and utilities, generating higher productivity and living standard growth. As a result, in the 1990s, Australia's productivity and living standards grew much faster than in the preceding three decades. By 2001, Australians were around 55 per cent better off than in 1980, after adjusting for inflation.

As Australia globalised, its economy and exports also have become more diversified. As trade and investment barriers fell from the 1980s, Australia's manufacturing and services sectors became more efficient and they now provide over 40 per cent of Australia's exports, providing new jobs and income growth. Domestic reforms and a globalised economy also help Australia to remain a profitable exporter of minerals and agricultural products, even though the latter often confront high trade barriers. While agricultural producers in protected economies typically resist reforms and remain inefficient, Australia's agricultural sector is open to world markets, boosting farm efficiency.

GLOBALISATION PART OF EAST ASIA'S SUCCESS

Opening to world markets also has been central to East Asia's rapid growth over the last 30 years, delivering more people from poverty more quickly than ever before in human history. Labour intensive export oriented industries productively employ millions of surplus agricultural workers across the region and foreign direct investment provides new skills, technologies and markets vital to expanding exports. East Asian governments generally created the policy environment to support this success, investing in education and infrastructure, operating stable macroeconomic policies and providing political stability. As a result, in just 12 years from 1987 to 1998, the number of East Asian citizens living below the international poverty line of US\$1 per day dropped from 417 million to 267 million. However, to encourage FDI and domestic investment and regain past growth rates, East Asian governments are aware they must strengthen market discipline and regulation of their financial and corporate sectors.

IMPLICATIONS

Over the past three decades, the experience of Australia and successful East Asian countries shows that economies gaining most from globalisation have governments which provide effective and accountable economic policies and institutions, flexible markets, efficient infrastructure and quality mass education and training. Opening international markets to developing country exports is a key priority to help low income countries gain from globalisation; all economies also would gain significantly from further trade and investment opening, including through the WTO's current Doha Round. Development assistance to help regional economies strengthen their key economic institutions also can help our neighbours maximise their gains from globalisation.

GLOBALISATION SUPPORTS GROWTH AND EQUITY

KEY POINTS

- In recent decades, globalising, export oriented economies have grown considerably faster than inward focussed economies. In the 1980s and 1990s, economies that opened to global markets on average grew about four times faster than those that did not, increasing their populations' living standards and reducing poverty faster than more closed economies.
- Over the past 30 years, mainly due to strong growth in globalising East Asia, world poverty has declined. However, poverty increased significantly in more inward looking economies, many of which also were poorly governed economies.
- Globalisation does not create a 'race to the bottom' for labour or environmental standards; wages and environmental standards typically rise faster in globalising economies.
- But for the benefits of globalisation to be fully realised, the right domestic policy settings are essential.
- Globalisation places a premium on open, transparent and accountable economic, legal, administrative and political settings.

A growing body of evidence suggests globalisation helps to drive economic growth, reduce poverty and improve global equity and, in the long run, also contributes to better environmental outcomes.

Globalisation is not inevitable and is reversible. It arises from individual economies actively choosing to engage with the global economy. Only in the 1990s have levels of international economic integration surpassed those achieved a century ago (World Bank, 2002a). In the twentieth century, World War I and the Great Depression turned governments away from interaction with the global economy. They raised trade barriers and restricted foreign investment, cutting economies off from traditional markets, deepening the Depression and sowing the seeds for World War II.

Far from weakening governments' influence, globalisation increases the need for effective domestic policies and institutions to allow citizens and corporations to prosper in open markets. Governments need to understand how best to use globalisation to maximise community welfare and so maintain local support for it. Sound domestic policies, including building effective, transparent and accountable institutions and ensuring domestic markets function effectively, are crucial in this process.

GLOBALISATION AND GROWTH

All else being equal, the majority of statistical studies indicates openness to trade and foreign investment helps economies grow.

Trade and Economic Growth

A recent World Bank study of 72 developing economies found that since 1980, the 'globalisers', those that increased their ratio of trade to gross domestic product, GDP, grew almost four times faster than those that did not (Figure 1.1) (World Bank, 2002a; Dollar et al., 2001).¹ These globalising economies also grew faster than developed economies and actually closed the income gap with these wealthier economies. In the 1990s, globalising economies, including China, India, Malaysia, Brazil and Mexico, grew on average 5.0 per cent annually, while non-globalisers grew only about 1.4 per cent per year. Non-globalisers grew relatively quickly in the 1960s but during the 1970s the gap with globalisers narrowed appreciably and in the 1980s and 1990s they fell far behind the globalisers as their inward looking, import substitution policies failed to deliver continual growth.

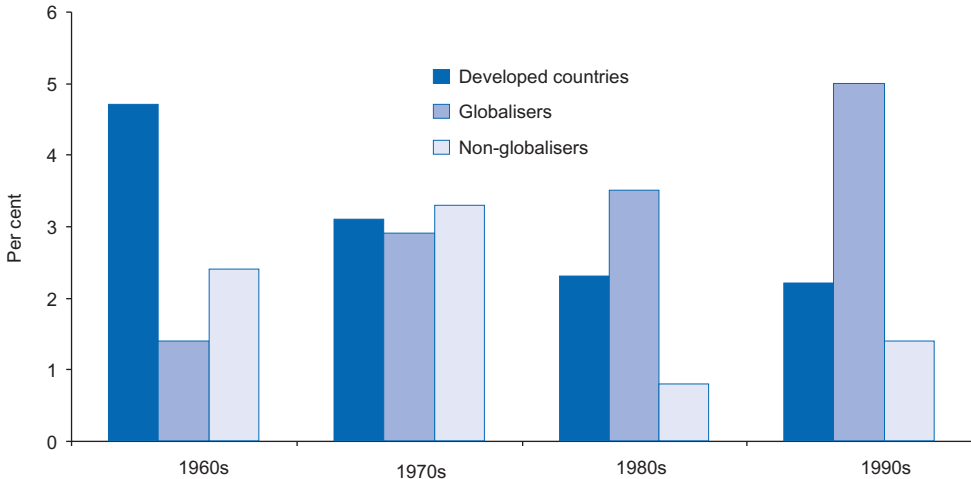
Significantly, globalisers have reduced their average tariffs by 34 percentage points since 1980, increasing their trade exposure (Dollar et al., 2001).

¹ Globalisers are defined as the top one third of 72 developing countries in terms of their growth in trade as a ratio of GDP between 1975-79 and 1995-97 in constant local currency units. Non-globalisers are the remaining developing countries in this group (Dollar, et al., 2001).

Figure 1.1

Globalisers Growing Faster Than Non-globalisers

Decadal Average Annual GDP Growth for Developed, Globalising Developing and Non-globalising Developing Economies



Notes: Developed countries include the OECD countries plus Chile.

Globalisers are defined as the top one third of 72 developing economies in terms of their growth in trade as a share of GDP between 1975-79 and 1995-97 in constant local currency units.

Non-globalisers refer to the remaining developing economies in this group.

Source: Dollar et al., 2001.

An earlier large cross country study found an increase in the ratio of trade to GDP by 1 percentage point raised real per capita income by 0.5 to 2.0 per cent (Frankel et al., 1999). Another found developing economies that were open grew on average 4.5 per cent per year in the 1970s and 1980s, while those with more closed economies grew on average only 0.7 per cent (Sachs et al., 1995). While other studies find open trade policies play a less important role in driving economic growth, no study identifies a developing economy closed to trade among the world's fastest growing economies (Rodriguez et al., 2000; Rodrik, 2000; Temple, 2001).

How Trade Promotes Growth

Trade helps an economy grow in several ways. First, it encourages economies to specialise and produce in areas where they have a relative cost advantage over other economies. Over time, this helps economies to employ more of their human, physical and capital resources in sectors where they get the highest returns in open international markets, boosting productivity and the returns to workers and investors. For example, most developing East Asian economies specialise in producing labour intensive goods like clothing, footwear and horticultural products, in which their relatively abundant low skilled labour supplies give them a comparative advantage. Australia specialises in higher value added services and manufactures as well as agricultural and mineral products, reflecting its generally skilled work-force and abundance of land and minerals.

NEW WORD FOR AN OLD PROCESS

The word 'globalisation' emerged from near obscurity as a 1980s management term to become in the 1990s a popular, if somewhat controversial, way of describing the process of global economic integration (Table 1.1). However, the trend to international integration is not new. By the end of the nineteenth century, the 1860 Anglo-French Trade Treaty and cheaper shipping costs expanded international trade flows to almost 10 per cent of world GDP. Capital flows expanded even more quickly; by 1914, the stock of foreign direct investment, FDI, reached around one third of developing economies' GDP (World Bank, 2002a). Partly as a result of this fast growth in trade and FDI, real global per capita incomes grew 1.3 per cent per annum in the 50 years to 1913, more than double the rate during the preceding 50 years.

However, from 1914, increasing tariffs and new barriers to capital flows markedly reduced trade and investment flows, contributing to the Great Depression. Between 1929 and 1933, the Smoot-Hawley tariff reduced US imports by 30 per cent and US exports also declined by 40 per cent. By 1950, exports as a share of world income had declined to around 5 per cent, equivalent to their 1870 level (World Bank, 2002a). After World War II, world leaders recognised protectionism in the 1920s and 1930s contributed to depression and world war. A second wave of globalisation commenced after WWII with the signing of major international treaties forming the United Nations, the International Monetary Fund, the World Bank and the General Agreement on Tariffs and Trade, the forerunner of the World Trade Organization. Trade flows increased rapidly as trade barriers declined and transport costs fell. Initially developed economies led with trade opening, but since the 1980s, developing economies have joined this process.

Table 1.1

A Global Word

Articles and Books with the Words 'Global' or 'Globalisation' in Their Title

	1980	1985	1990	1995	1998
Sociological Abstracts	89	142	301	1068	1009
Politics and International Relations	64	101	309	366	698
Historical Abstracts	69	81	103	166	157
Anthropological Literature	6	2	6	16	34
Books in Print	48	92	328	689	589

Source: World Bank 2002a.

Second, trade expands the markets local producers can access, allowing them to produce at the most efficient scale to keep down costs. Even in populous developing economies, low incomes often make producers' potential local market small, so trading with the world is vital. Third, trade diffuses new technologies and ideas, increasing local workers' and managers' productivity. For example, one US study found a doubling of research and development spending in trading partners' economies increased US productivity by 2 per cent, controlling for other factors, showing how technologies spread (Lewis et al., 2001). Technology transfers through trade and investment are even more valuable for developing economies, which employ less advanced technologies and typically have less capacity to develop new technologies themselves. Finally, removing tariffs on imports gives consumers access to cheaper products, increasing their purchasing power and living standards, and gives producers access to cheaper inputs, reducing their production costs and boosting their competitiveness.

Trade and Productivity

Firm level studies also suggest freer trade can increase firms' productivity. In Taiwan and China, studies indicate exporting companies' productivity increases faster than similar companies which do not export (Lewis et al., 2001; Perkins, 1997). In the previously relatively closed markets of Japan and the Republic of Korea, other research suggests import competition has benefited manufacturing productivity strongly (Yusuf et al., 2001).

FDI and Economic Growth

Many studies explore the links between foreign direct investment, FDI and economic activity; the large majority finds FDI benefits recipient economies.² Accessing foreign savings helps economies grow faster and in the case of developing economies this additional investment can be crucial in helping them catch up to developed economies' income levels (Barro et al., 1995). Foreign investors can provide new markets for local firms supplying inputs to these ventures, provide market access in the foreign investor's home and third country markets and generate competition for local firms. Larger markets and increased competition can expand local firms' output and efficiency, supporting economic growth (Graham, 2001). FDI also transfers new technologies and skills to host economies; in recent years, several studies have found FDI is particularly effective in accelerating take up of 'new economy' technologies (Asia Pacific Economic Cooperation, 2001; Graham, 2001).

A recent study of 20 developed and 20 developing economies found FDI had a strong positive effect on economic growth, after holding other factors constant (McLean et al., 2002). In the developing countries, a 1 per cent increase in FDI in developing economies on average increased growth in per capita GDP by close to 0.5 per cent (McLean et al., 2002). By contrast, several studies find often volatile, short term foreign bank lending and portfolio investment fail to promote growth in recipient developing economies (Klein et al., 1999; Edwards, 2001).³

² FDI involves companies and individuals directly investing in companies and other productive assets beyond their home economy, either in green field operations or by mergers and acquisitions, in joint ventures with local firms or as wholly foreign owned ventures.

³ While developed countries, including Australia in the 1980s, also experience domestic banking crises due to poor risk management, they tend to be less prone to crises induced by foreign bank lending; a recent study suggests foreign bank lending does promote growth in developed economies (McLean et al., 2002). Studies find developing economy banks, capital markets and most importantly regulatory institutions are less likely than developed countries' to allocate such funds reliably to high return investments which can repay foreign lenders and shareholders (Klein et al., 1999; Edwards, 2001).

SHORT TERM CAPITAL FLOWS LESS STABLE THAN FDI

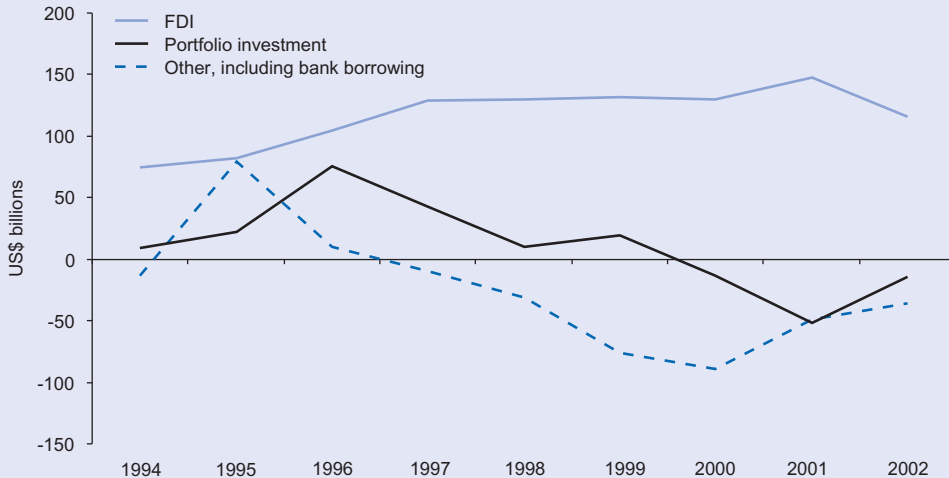
The 1997 Asian financial crisis demonstrated that while FDI is a relatively stable form of capital inflow, shorter term capital inflows, including foreign bank borrowing and portfolio (share market) capital flows are inherently more volatile (Figure 1.2). Most studies find short term inflows promote growth only when domestic capital markets are efficient and governments enforce effective regulatory frameworks (McLean et al., 2002). (See Chapter 2 – *Domestic Policies Matter.*)

During the Asian crisis, many foreign lenders lost confidence and rapidly pulled short term bank loans and portfolio investment out of East Asia. This sharply depreciated exchange rates, causing a major credit squeeze and increasing the domestic value of foreign debts, putting many local bank and corporate balance sheets into the red. By contrast, FDI flows remained reasonably stable throughout the crisis.

Figure 1.2

Volatile Portfolio and Bank Lending Contributed to the 1997 Asian Financial Crisis

Net Private Capital Flows to All Developing Economies, US\$ billions



Note: Graph covers all developing economies of which East Asian developing economies comprise a large share.

Source: International Monetary Fund, 2002a.

GLOBALISATION ASSOCIATED WITH BETTER GLOBAL POVERTY AND EQUITY OUTCOMES

Many studies show globalising economies are growing more quickly than non-globalisers, catching up to developed economies and hence reducing poverty and inequality in world incomes.⁴ However, government policies remain powerful determinants of growth and equity outcomes even in those economies open to international trade and investment.

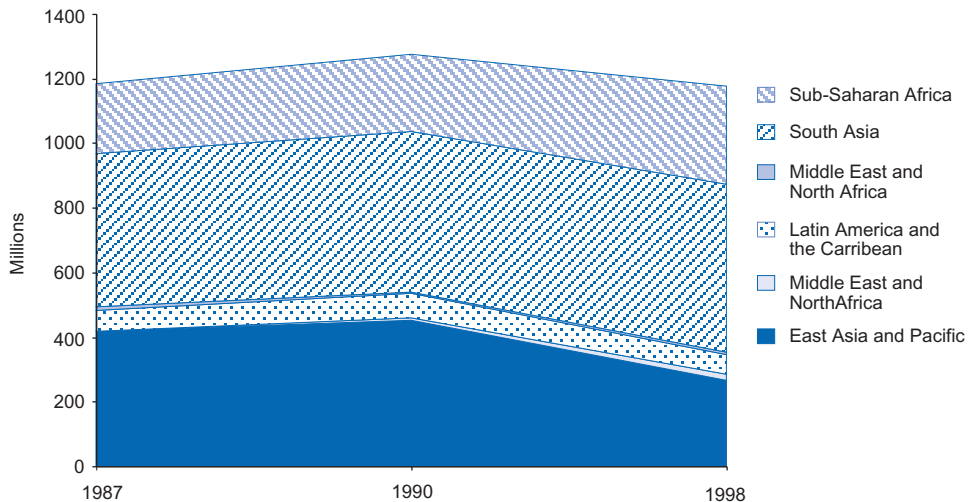
Globalisation and World Poverty

The links between globalisation and poverty are complex. Most research suggests economic growth is vital to reducing poverty. As discussed, the balance of evidence suggests globalisation can help economies grow and hence reduce poverty. Recent World Bank research found that over the past two decades, rapid growth and stable or improving income distribution combined to reduce poverty in developing economies that lowered their barriers to trade, many of which are in East Asia (World Bank, 2002b). Between 1987 and 1998, the number of people in East Asia and the Pacific living in poverty declined by 150 million to 267 million (Figure 1.3) (World Bank, 2002b). In China alone the number of people living in poverty declined by 90 million to 213 million over this 12 year period (World Bank, 2002b).⁵

Figure 1.3

Globalising Asia Contributing to Lower World Poverty

Global Poverty by Region



Note: Based on the number of people in each region living below US\$1 per day (World Bank, 2002b).

Source: World Bank, 2002b.

⁴ The international definition of poverty is having less than US\$1 per day per person to live on.

⁵ Another study showed that from 1993 to 1998, the number of people living in poverty in all globalising developing economies declined by 14 per cent, or 107 million people, to 702 million (World Bank, 2002a).

According to the World Bank, globalising economies also improved other social and economic indicators including average years of schooling and life expectancy over the last two decades. By the late 1990s, globalising developing economies' social indicators on average equalled developed economies' 1960 levels (World Bank, 2002a).

By contrast, the World Bank found poverty is growing in developing economies that are relatively closed to world trade and investment and these economies also suffer from lower school enrolments and life expectancy than globalisers (World Bank, 2002a). For example, very few Sub Saharan African economies, except Uganda and Botswana, are in the globalising economies group; most adopted inward looking development strategies, with high protection and controls on FDI and also have weak governance. Between 1970 and 1998, the number of people in Africa living below the international poverty line rose by over 175 million.⁶ Agricultural trade barriers in many developed economies also inhibit those African economies which seek to achieve export oriented growth through agricultural products (Economic Analytical Unit, 2003). In 1960, Africa was home to only around one in ten of the world's extremely poor, but by 1998, this share had risen to two out of three (Sala-i-Martin, 2002).

Between 1980 and 1998, the net effect of these diverging regional trends was a decline in global poverty by around 200 million people (Bourgignon et al., 2001; Chen et al., 2001).⁷ These net declines in world poverty occurred despite the world's population rising by around 2 billion over the same period.

Globalisation and World Equity

World Bank and other studies have found globalising developing economies are growing more quickly than developed economies and closing the gap in per capita income levels with developed economies, contributing to lower inequality between countries, or 'between-country inequality' (Figure 1.1) (World Bank, 2002a; Dollar, 2002; Sachs et al., 1995; Clark et al., 2001). Furthermore, between 1960 and 1995, as developed economies became more globalised, inequality between them more than halved (World Bank, 2002a).

⁶ Between 1993 and 1998, the World Bank found that poverty rose 4 per cent in non-globalising developing countries, or by 17 million people, to 437 million people (World Bank, 2002a).

⁷ These data differ from Figure 1.3's because of the different periods covered.

ECONOMIC GROWTH IS VITAL FOR REDUCING POVERTY

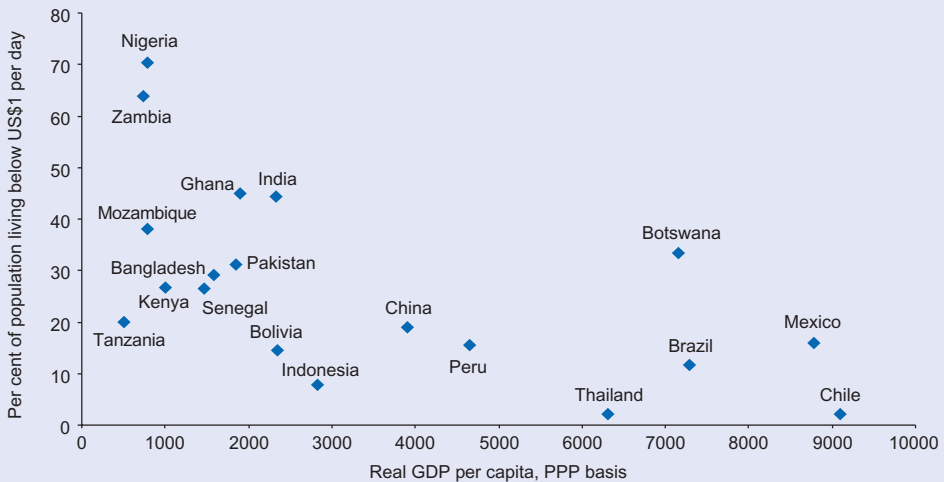
As economies’ average income levels increase, the proportion of people living in poverty generally falls (Figure 1.4). As shown previously, studies also find globalisation promotes economic growth (Figure 1.1).

Figure 1.4 also shows other factors apart from an economy’s average per capita income influence poverty outcomes. For example, although Indonesia’s real GDP per capita on a purchasing power parity, PPP, basis is only 20 per cent higher than India’s, the proportion of its population living in poverty is less than a fifth of India’s. Domestic policies including on access to education, land reform, taxation, infrastructure provision and inflation control also directly influence poverty levels.⁸ (See Chapter 2 - *Domestic Policies Matter.*)

Figure 1.4

Economic Growth Important to Reducing Poverty

Real Per capita Income and Rates of Poverty for Developing Economies, 2000, International dollars, Per cent of Population Living in Poverty



Note: The purchasing power parity, PPP, approach to calculating real GDP values the total bundle of goods and services a population consumes each year at the price they would cost in the United States. Hence PPP per capita income adjusts ordinary US dollar measures of per capita income to take account of the fact goods and services that are not traded internationally but are sold in developing, and even other developed, economies may be cheaper than in the United States.

Source: World Bank, 2002b; CEIC, 2002.

⁸ Botswana is an obvious outlier in the figure above, despite its generally good governance policies. This is because Botswana’s diamond production makes a major contribution to GDP, but many of its population are still nomadic, reducing their capacity to participate in the modern economy.

Domestic Factors Drive Inequality within Economies

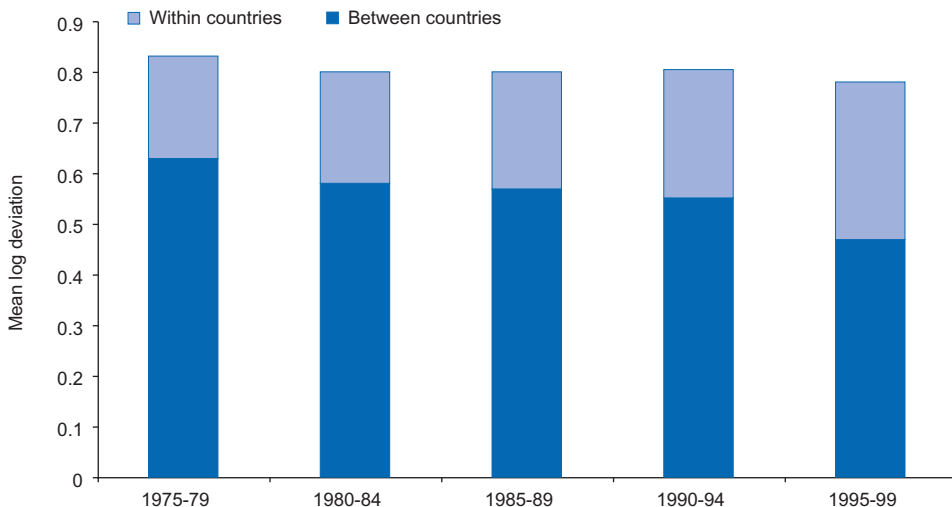
However, several studies find inequality within developed economies and globalising developing economies, known as ‘within-country inequality’, has widened marginally. Growing inequality in China, which accounts for one third of globalising developing economies’ population, mainly explains the deteriorating equity within globalising developing economies. However, in the 1990s, China’s widening rural-urban income gap was due largely to domestic agricultural pricing policies and restrictions on labour mobility rather than increased globalisation (World Bank, 2002a). Most studies find freer international trade directly contributes little to greater inequality in either developed or developing economies as domestic policy settings are more important in creating or reducing inequality (Dollar, 2002). (See Chapter 2 – *Domestic Policies Matter*.)

According to the World Bank, the long term decline in between-country inequality has more than offset the rise in within-country inequality, producing a slight decline in worldwide household inequality between 1975 and 1999 (Figure 1.5) (World Bank, 2002a).

Figure 1.5

World Household Inequality Gradually Falling

Global Household Inequality, within and between Countries, Selected Periods, Mean Log Deviation



Note: The mean log deviation is a measure of the spread of income inequality between households, here shown both within and between economies. A higher reading means more inequality.

Source: World Bank, 2002a.

UGANDA LEADS THE WAY FOR AFRICA

Due to its good record on governance and open economy Uganda has grown rapidly, albeit from a low base, for the last 15 years. In 1986, the Ugandan Government began dismantling its complex system of trade barriers. By the late 1990s, Uganda enjoyed one of the freest trading regimes in Africa and also offered a welcoming environment for FDI. Uganda operates only 3 tariff bands: a maximum tariff of 15 per cent on consumer goods, 7 per cent for intermediate goods and zero tariff rates on capital goods.

Between 1986 and 1999, Uganda grew on average 6.3 per cent per annum and in the 1990s its growth averaged 6.9 per cent. Despite being a largely agricultural economy, it grew much faster than most African economies, including many with substantial mineral reserves and exports. In the 1990s, Uganda's real exports grew by an annualised rate of 15 per cent and imports by 13 per cent. Importantly, Uganda diversified its exports, with non-coffee exports increasing five fold between 1992 and 1999. According to the World Bank, strong economic growth helped reduce the proportion of the population living in poverty from 56 to 36 per cent between 1993 and 2000 and the government is on track to achieve its aim of having no more than 10 per cent of the population living in poverty by 2017.

Source: Dollar, 2002; World Bank, 2002a; International Monetary Fund, 2002b.

NO RACE TO THE BOTTOM

Globalisation and Labour

Strong evidence suggests globalised economies also typically offer faster wages and employment growth than inward looking economies. By exporting labour intensive manufactures and agricultural products globalised developing economies increase demand for unskilled labour, eventually driving up their wages, as surplus labour is absorbed (Lukas, 2000). A study of 150 economies showed that, controlling for all other factors, a 1 per cent increase in the ratio of trade to GDP increased income per person by between 0.2 and 0.5 per cent, mainly through higher wages (Frankel et al., 1999). FDI inflows to developing economies expand the demand for local labour, increasing wages. Moreover, the technology and management advantages FDI brings enhances workers' skills and productivity, also lifting average incomes.

STUDIES SUGGEST GLOBALLY ORIENTED FIRMS GOOD FOR WORKERS

Many community and firm level studies show export oriented companies provide better conditions for workers than those that do not export. For example, one study found globally oriented US companies operating in the United States pay 5 to 20 per cent higher wages than other companies. They also grow more quickly and employ more people over time than similar non-exporting firms, in some cases rejuvenating depressed sectors. Even companies that export only a small share of their output employ 2 to 4 per cent more people, sell 1 per cent more per year and are 8.5 per cent less likely to go out of business than non-exporting firms. Blue collar workers in exporting companies receive 13 per cent higher wages than those in non-exporting companies.

The productivity of US companies with foreign ownership, even as small as 10 per cent, also has increased more quickly than wholly domestically owned firms. They achieve cost advantages by importing a greater share of their intermediate components and adopt new technologies more rapidly, lifting their productivity 12 per cent above that of similar wholly owned local companies.

Studies also suggest globalisation exerts a strong positive influence on Australian firms. (See Chapter 4 – *Globalisation Transforms Australia.*)

Source: Lewis et al., 2001.

Most studies show foreign companies pay their workers more than local companies and the differential increases in poorer economies (Table 1.2) (Graham, 2001; Aitken et al., 1999). In Australia, analysis suggests foreign owned companies pay about 5 per cent more than local companies, taking account of other factors including capital per worker and the level of human capital (Bora et al., 1998). In most cases, foreign multinationals also offer superior workplaces and conditions to local operations. For example, some labour groups in Indonesia believe foreign hotel groups offer better conditions and show greater respect for labour rights than many local operators (Dharmabumi, 2002).

Table 1.2

**Study Shows Foreign Manufacturers Pay More than Local Companies
Average Wages, US Multinationals, US\$ thousand, 1996**

	All Economies	High Income	Middle Income	Low Income
Average FDI company manufacturing wage	15.1	32.4	9.5	3.4
Average domestic company manufacturing wage	9.9	22.6	5.4	1.7
Ratio	1.5	1.4	1.8	2.0

Source: Graham, 2001.

Where they exist, poor labour standards and the use of child labour usually involve local operators and reflect weak domestic laws and enforcement rather than globalisation (Graham, 2001). Of the around 250 million children under 14 currently working in developing countries, the great majority work on family farms. Of the remainder, most work in informal service sectors like hawking; relatively few are involved in export industries (Organisation for Economic Cooperation and Development, 1996; International Labour Organisation, 1998).

Globalisation and the Environment

At least in its early stages, industrialisation can impose stress on an economy's environment but, as incomes rise, environmental outcomes improve again until typically they surpass pre-industrial levels. These trends can create a 'U' shape relationship between economies' income levels and environmental quality.⁹ As industry expands, land is cleared, pressure on traditional water supplies increases and industries often produce air, water and solid waste pollution (Graham, 2001). However, as incomes rise further, environmental quality usually improves for a number of reasons.

First, rising per capita income increases child survival rates and education levels, lowering fertility rates and overall population growth, reducing environmental pressure. In many developed economies, population is forecast to decline in the next 50 years. By contrast, the world's poorest economies experience the highest rates of population growth (Graham, 2001).

Second, as incomes rise, people demand a better environment, increasing the pressure for better regulation of pollution and government spending on pollution abatement.

Third, as incomes and productivity rise, economies can better afford to increase costs to producers and consumers by employing more pollution abating technologies and to levy taxes to establish regulatory agencies enforcing anti-pollution regulations.

Last, as incomes rise, economies can better afford to designate large areas of their land and sea zones as national parks, protecting valuable regions from further encroachment (Graham 2001).

As globalised economies grow faster than inward looking economies, they can move more quickly to higher income levels where they can enjoy better environmental outcomes. Many developing economy populations are rising rapidly, putting their natural resources under pressure. Advocating policies which would leave these economies at this development stage would worsen total world environmental outcomes and condemn these populations to long term poverty and deteriorating environments.

Little evidence exists for the view that poor globalising economies lower environmental standards to attract FDI in environmentally damaging activities in a so called 'race to the bottom' (Graham, 2001). Most FDI flows to developed economies where environmental standards are high and very little goes to poor regions with weak environmental standards (Eskeland et al., 1997).

Globalisation also can improve environmental outcomes directly. FDI and trade often introduce more efficient technologies that often use fewer resources and generate less pollution (Dua et al., 1997). Trade also can allow economies to import renewable substitutes instead of using scarce domestic natural resources. For example, in the past few years, the Chinese Government has prioritised re-afforesting large tracts of marginal land throughout China to prevent flooding, soil erosion and dust storms and now is importing significant quantities of cut renewable plantation timber to meet local demand (Economic Analytical Unit, 2002b). In such ways, trade can help reduce and ultimately reverse the environmental impact of early industrialisation stages and related high population growth.

In both open and closed economies, governments remain responsible for managing the environmental costs of economic activity, and for imposing and enforcing regulations and standards. Efficient and accountable institutions and political will are needed to achieve satisfactory environmental outcomes.

IMPLICATIONS — DOMESTIC POLICIES CRITICAL

Strong evidence exists that globalising economies are growing faster, reducing poverty more rapidly, catching up with developed economies and hence reducing world inequality. Evidence also suggests globally oriented firms pay higher wages and open economies eventually achieve higher environmental standards.

However, sound domestic policies also are essential for growth. Strong economic governance is needed to ensure markets work, so investment is efficient and sufficient investment occurs in human capital and public goods like infrastructure as these are the major long term drivers of growth. Governments also usually need to ensure all citizens have the opportunity to participate in economic growth.

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DOMESTIC POLICIES MATTER

KEY POINTS

- While opening to world markets is essential for economies to improve their populations' living standards and reduce poverty, this forms only part of a successful development strategy. The quality of domestic policies and institutions also strongly influences the scale and distribution of benefits from opening to world trade and investment.
- Globalisation in fact increases the importance of getting domestic policies right. Without efficient local labour, financial and goods markets, firms cannot respond to new trade and investment opportunities in the global marketplace. Poorly functioning markets also can increase the social cost of adjusting to free trade and vulnerability to volatile short term capital flows.
- Economic and corporate governance and economic development are linked closely. For example, transparent and accountable legal and regulatory systems help ensure goods and capital markets work and contracts can be enforced. This increases economies' ability to attract and productively use foreign and local investment.
- Governments also need to ensure populations receive efficient social and physical infrastructure services so workers and businesses can respond to the opportunities open markets generate.
- Domestic policies also are vital for ensuring all groups in society benefit from globalisation. In particular, it is critical to invest in education and training for all segments of society.

DOMESTIC POLICIES CRUCIAL FOR SUCCESSFUL GLOBALISATION

Domestic policy settings are central to whether economies capture the gains from freer trade and investment flows and whether the population as a whole gains equal access to these opportunities. To maximise globalisation's benefits for growth, government policies must deliver functioning markets, effective property rights, stable macroeconomic policy, effective and accountable regulatory settings and enforcement and efficient social and physical infrastructure services. Governments also play an important role in promoting equity and ensuring disadvantaged groups are not left behind as incomes rise in globalising economies.

FUNCTIONING DOMESTIC MARKETS

Consumers and investors need efficient goods, services, labour and capital markets to respond to new global opportunities and incentives.

Goods and Services Markets

A domestic economy in which producers and consumers can respond to market prices is essential if they are to access the opportunities of globalisation. Firms relying on state ownership, monopoly power, subsidies or regulated exchange rates or prices usually find it difficult to compete in world markets. Hence, prior to opening their economies, governments need to remove as many artificial constraints on market prices as is possible without compromising social objectives. By promoting competition in the economy, governments help keep input prices low so local producers can compete internationally.¹

For example, over the past 20 years, Chinese authorities have dismantled the great majority of price controls which once covered virtually all local goods and services, improving the ability of producers to compete in international and increasingly free domestic markets. In 2001, anticipating WTO entry, authorities removed price controls on 128 categories of goods and services; markets now determine 90 per cent of all retail and agricultural prices (Economic Analytical Unit, 2002b; *South China Morning Post*, www.scmp.com, 12 July 2001). Only strategic commodities like petroleum, coal, wheat and rice retain price controls and many of these prices are close to international levels.

Similarly, the Mexican Government dismantled many price controls as it liberalised trade under the North American Free Trade Agreement, helping Mexican manufacturers compete. However, some remaining price controls hamper sectors like agriculture (Economic Analytical Unit, 2001b).

As an economy opens to trade, higher profits attract investors to sectors in which the economy is most competitive and lower profits or losses encourage firms to leave other sectors. For example, in the four years following their opening to global markets, higher competition saw from 25 to 33 per cent of Chilean, Colombian and Moroccan manufacturers enter or leave their industry, well above normal rates of firm turnover (World Bank, 2002b). This 'churning' increased the need for efficient markets to reallocate finance and labour to new firms.

¹ This is especially important in infrastructure sectors like electricity and transport as these provide basic inputs to all other industries.

Labour Markets

Open economies' labour markets must operate efficiently so labour can move smoothly into expanding sectors and out of contracting ones. Country studies suggest efficient labour markets shorten periods of unemployment, enhance labour productivity and minimise social dislocation. However, many developing and some developed economy governments attempt to set minimum wages for unskilled labour above the market clearing level, so it becomes too expensive for local firms to employ all potential workers. This policy contributes to unemployment and prevents local firms succeeding in global markets, particularly for labour intensive products. For example, the Philippines' high minimum wages for low skilled workers undermine the export competitiveness of its labour intensive industries like clothing and footwear, even those in export processing zones that use duty free inputs (Philippines Export Processing Zone, 2002).

Strong unions also can push wage levels above market clearing levels, again creating unemployment (Fosu, 2000). For example, in South Africa, analysts consider centralised wage bargaining compresses real wage differences across skill levels reducing the economy's competitiveness in labour intensive manufacturing and contributing to South Africa's 30 per cent unemployment rate (Baxter, 2003). Other studies find restrictive workplace dismissal laws deter firms from hiring new workers. Countries including India, Argentina, Mexico and Brazil suffer from such restrictions, keeping formal sector employment growth low (Bahia Guimarães, 2001; Economic Analytical Unit, 2001a, 2001b).²

Capital Markets

Efficient domestic financial markets also are essential so open economies can expand investment in internationally competitive sectors and move capital out of uncompetitive ones, maintaining output and employment growth. 'Relationship' or connected lending based on links between bank and corporate owners rather than rigorous risk assessment often disadvantages new entrants, hindering the growth of new firms and sectors. Firms cannot move easily into newly competitive sectors if domestic banks or financial markets will not finance viable new projects, instead maintaining credit lines to unviable firms in uncompetitive industries. For example, in the last decade, the Japanese and Chinese banking systems were reluctant to withdraw credit from declining sectors and firms and divert it to growing firms (Economic Analytical Unit, 2002a; East Asian Analytical Unit, 1999). Small and medium firms' lack of access to finance often frustrates their attempts to respond to new market opportunities, especially in rural areas where few banks operate.³ Interest rate controls and other policies preventing banks correctly assessing and pricing risk also hinder banks lending to firms in new growth areas.

² Rigid labour markets can be particularly costly when economies become more open. For example, after reducing tariffs in the 1980s, Chile's unemployment rose 3.5 percentage points because high minimum wages prevented the export sector from absorbing labour from sectors that were previously protected (Edwards et al., 1991).

³ However, China continued to achieve strong growth in most years since the early 1980s because many small and medium sized firms financed themselves from internal and informal sources and FDI also contributed to investment growth.

Government owned banks and government interference in private sector credit decisions often cause excessive lending to officially preferred, often low return and protected sectors. For example, in many South East Asian economies state owned banks contributed to the 1997 Asian financial crisis by lending excessively to protected heavy and high technology industries, inefficient state owned enterprises and overbuilt real estate sectors (Economic Analytical Unit, 2002a). They often ignored the financing needs of more efficient small scale firms in internationally competitive services and labour intensive industries. Since the crisis, regional governments have sought to increase the efficiency of local banks and capital markets, including by allowing foreign financial institutions to compete with local firms (East Asia Analytical Unit, 1999).

STRONG INSTITUTIONS VITAL

Economies with effective and accountable institutions benefit much more from globalisation than those with weak or opaque institutions and legal systems. International investors also place a premium on economies with sound institutions.

Strong Institutions Help Developing Countries Catch Up

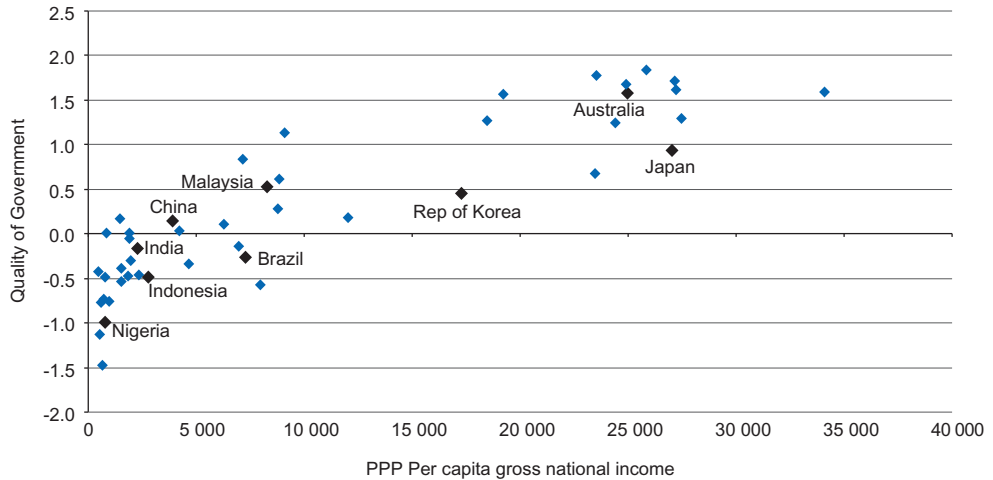
Strong institutions appear to be a major determinant of development (Figure 2.1) (Kaufman et al., 2002b).⁴ One study found secure property and contractual rights increase the speed at which developing economies grow, nearly doubling the rate at which developing economies catch up with developed economies (Knack et al., 1995). Other studies confirm this picture, finding weak domestic governance can allow elites to capture most of globalisation's benefits and encourage firms to lobby for rents rather than pursue productivity gains, significantly reducing growth rates (Rama, 1993). High corruption levels reduce growth by increasing risks for producers and deterring investment (Knack et al., 1995). Bureaucrats, judges and politicians who allocate public goods and licences or enforce laws and regulations in return for bribes undermine their countries' legal and regulatory framework, encouraging inefficient investment, discouraging foreign direct investment, FDI, reducing growth and exacerbating inequality (Knack et al., 1995; Garibaldi, et al., 2001; Hoekman et al., 1999). For example, starting a legal business in Bolivia takes 20 procedures, 88 business days and 266 per cent of average annual income; in Australia, it takes two procedures, two days and 2 per cent of average annual income (World Bank, 2002a).

⁴ While evidence suggests strong institutions promote growth, little evidence indicates that strong growth and high incomes promote effective institutions (Kaufmann et al., 2002a).

Figure 2.1

Close Links between Governance and Development

Scatter Plot of Economies' National Income, Per capita PPP basis, and Quality of Government Measure



Note: Based on a survey of 46 countries' quality of public service provision and bureaucracy, civil service competence and credibility of government policy. See Kaufmann et al., 2002b for more details.

The purchasing power parity, PPP, approach to calculating real GDP values the total bundle of goods and services a population consumes each year at the price they would cost in the United States. Hence PPP per capita income adjusts ordinary US dollar measures of per capita income to take account of the fact that goods and services sold in developing and even other developed economies and not traded internationally may be cheaper than in the United States.

Source: Kaufmann et al., 2002b.

A TALE OF TWO ECONOMIES

In the 1990s, Russia and Poland both faced serious challenges in their transition from centrally planned to market economies. While both opened to trade, FDI and capital flows throughout the 1990s, Poland also comprehensively reformed its institutions, improved policy making procedures and enhanced community participation. Polish authorities strengthened property rights and prudential controls for the financial system and built a competitive market sector through targeted privatisations and industrial modernisation. Parliament and the media led inclusive debates on economic reforms, increasing community ownership and support for new policies. Human development indicators improved markedly over the 1990s.

In contrast, Russia did not reform governance and property rights systems prior to opening its economy; consequently corruption and crime increased. Poorly targeted, non transparent privatisations and economic restructuring aggravated inequality and concentrated economic power in a few hands. Between 1989 and 1996, inequality doubled and labour's share of national income fell from 74 per cent to 55 per cent. By 1996, Russian life expectancy had declined by more than four years.

As a result of its governance policies, Poland achieved superior economic and social outcomes to Russia and arguably has benefited more from globalisation than Russia. Between 1991 and 1997, Poland attracted US\$18 billion in FDI or US\$466 per capita, compared with Russia's US\$13 billion, or only US\$88 per capita. By 2002, Poland had a PPP per capita income of International Dollars, ID\$9 200, up from ID\$4 500 in 1992, while Russia's per capita PPP income was ID\$8,660, only modestly up from ID\$6 930.

Source: United Nations Development Programme, 1999; World Bank, 2003; World Bank, 1994.

Property Rights

Secure property rights are essential to enable the safe and efficient exchange of goods, services, savings and ideas. Many developing economies fail to define or protect basic property rights, limiting consumers', investors' and producers' ability to buy or sell goods, services, property or ideas. For example, few people in urban Philippines or India have legally enforceable titles to their dwellings or businesses. This prevents them from obtaining credit for investment or even easily buying or selling land and businesses (Borgonos, 2002; Economic Analytical Unit, 2001a). In transition economies, where property rights often remain weak, local and foreign firms on average reinvest fewer of their profits than firms in economies with better defined property rights (Johnson et al., 2001). Many African economies also have limited titling of rural land, reducing farmers' capacity to borrow and incentives to invest (Besley, 1995). Weak intellectual property rights in some economies also make it difficult for inventors to profit from their inventions, discouraging innovation.

Several economies have successfully reformed their property rights regimes as part of an overall market reform program. For example, in 1992, Mexico reformed its property rights system, transferring communal *ejido* lands to private hands, eliminating irregularities in land tenure and improving contract enforcement. Poland also has undertaken significant property right reforms speeding its transition to a market economy (United Nations Development Programme, 1999). Since the early 1980s, the Chinese Government has granted farmers long term leases on their land, increasing investment and output. In early 2003, the Chinese Government announced it would give farmers secure and transferable titles to their land to encourage plot consolidation, investment and farm efficiency (*China People's Daily*, 2 March, 2003). In the last decade, the Australian aid program successfully titled many traditional land owners in Thailand and Indonesia, significantly increasing farmers' economic security and investment capacity.

WEAK INSTITUTIONS UNDERMINE AFRICA'S EXPORTS

Strengthening African institutions would strengthen significantly the continent's export sector. A study of 49 African countries shows the quality of institutions has a major impact on individual economies' real export growth. Among indicators of institutional quality, the rule of law and the security of property rights have the clearest influence on export performance, after controlling for other factors including policy distortions and political instability. The study also finds the export sector typically plays little role in influencing economic policies, increasing the incidence of policy surprises and undermining rates of investment in the sector. Often corruption imposes informal taxes on exporters' efforts, reducing their success.

Source: Weder, 1998.

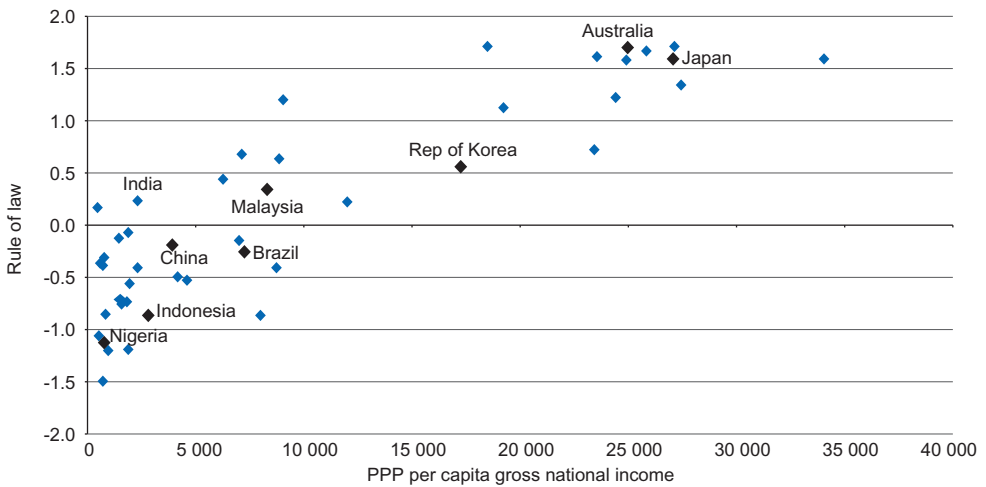
Enforcing Contracts

Integrating domestic markets with the global economy is difficult if buyers and sellers cannot make and enforce contracts. Strong evidence exists that economies with credible and predictable legal systems that protect contracts and creditor rights achieve faster financial development and investment growth than those without (Figure 2.2) (Beck et al., 2000; La Porta, 1998).

Figure 2.2

Rule of Law Supports Development

Scatter Plot of Economies' National Income, per capita PPP basis, and Rule of Law Measure



Note: Based on 46 countries' surveys of perceptions of the incidence of crime, the effectiveness and predictability of the judiciary and the enforceability of contracts. See Kaufmann et al., 2002b for more details.

PPP is purchasing power parity.

Source: Kaufmann et al., 2002b.

Since the 1997 Asian financial crisis, foreign and local investors are more aware of deficiencies in some regional economies' capacity to enforce contracts between creditors, debtors, suppliers and buyers. This market perception is slowing investment and growth rates (Economic Analytical Unit, 2002a; East Asia Analytical Unit, 1999). Studies of Eastern European transitional economies and Latin America also find weak legal systems reduce FDI inflows, bank lending and economic growth rates (Bevan et al., 2001; Economic Analytical Unit, 2001b).

GOVERNANCE AND TECHNOLOGY UP-TAKE

Accessing more advanced technologies is a major benefit developing economies can obtain from globalisation, boosting productivity and growth. However, a 2001 APEC study of the links between governance and technological change suggests developing economies often need to reform economic and legal policies and institutions before they can maximise the benefits of new technologies. For example, the study found producers usually need to borrow from financial institutions or access capital markets to purchase new technologies; if these markets are not functioning efficiently few producers may gain access to new technologies. Strengthening domestic competition laws and their enforcement also encourages firms to invest in new technologies. Evidence also suggests that liberalising FDI in services sectors like finance, business services, distribution and transport, which have experienced significant technological advances in the last decade, assists economies accelerate technological take up.

Source: Asia Pacific Economic Cooperation, 2001.

REGULATORY AND MACROECONOMIC INSTITUTIONS

To maximise community gains from globalisation and economic growth, economies need effective institutions to regulate financial markets and corporate behaviour and to achieve stable macro-economic management.

Regulatory Environment and Development

Studies show the close link between economic development and the quality of regulations (Figure 2.3). In particular, as bank lending is the main source of investment finance in most developing economies, appropriate bank supervision is vital to sustaining growth and reducing poverty. Poor prudential supervision contributed to the 1997 Asian financial crisis, the Mexican crisis in the early 1990s and the Latin American crisis of the 1980s.⁵ For example, prior to 1997, prudential authorities in Indonesia, Thailand, the Republic of Korea, ROK and to some extent Malaysia permitted banks to lend to connected parties, make an excessively large share of total loans to a few risky sectors like real

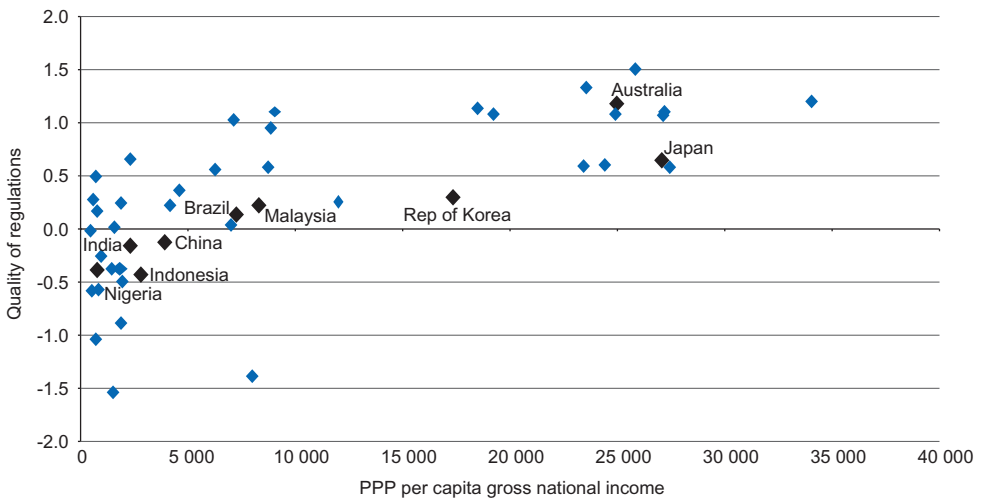
⁵ By contrast, Argentina's financial crisis in the 2000s was due mainly to excessive levels of government debt and its fixed exchange rate policy; its banking system and prudential controls now are reasonably sound (Economic Analytical Unit, 2001b).

estate and shares, hold a small share of total outstanding loans as capital or borrow in foreign currency from abroad for on-lending to local unhedged borrowers in local currency (East Asia Analytical Unit, 1999; Economic Analytical Unit, 2002a). Many regional policy makers now accept they must ensure domestic financial markets can rigorously assess risk and lend only on this basis before they open their economies to short term foreign capital inflows. For this reason, the Chinese Government remains reluctant to liberalise further short term foreign capital inflows until it completes reforms of its banking and state owned enterprise sectors. In the wake of the crisis, the international community also is attempting to help governments regulate volatile international capital flows more effectively. (See Chapter 3 – *Getting International Policies Right.*)

Weak corporate governance regulations also can increase the risks and cost of lending and investing in developed and developing economies, reducing growth. Limited protection of shareholders’ rights to hold management to account for their actions and failure to require corporates to disclose timely and detailed performance information to creditors and shareholders and implement internationally acceptable accounting norms have undermined investors’ confidence in corporates in several developing regional economies (Economic Analytical Unit, 2002a). However, since 1998, most regional governments have sought to strengthen these and other aspects of their corporate governance legislation and enforcement.

Figure 2.3

Effective Regulations Important for Development
Scatter Plot of Economies’ National Income, per capita PPP basis, and Quality of Regulations Measure



Notes: Based on a 46 country survey of perceptions of regulatory burden and the incidence of market unfriendly policies, including price controls. See Kaufmann et al., 2002b for more details.

PPP is purchasing power parity.

Source: Kaufmann et al., 2002b.

Sound Macro Policy Essential for Open Economies

Sound macroeconomic management also is essential if economies are to benefit from globalisation. To promote investment, assist export competitiveness and protect against financial crises, authorities need to deliver low and stable inflation, interest rates that reflect domestic credit supply and demand and flexible and competitive exchange rates (McKinnon et al., 1993). For example, holding exchange rates at uncompetitively high levels, as occurred in Latin America in the 1980s and much of East Asia in the mid 1990s, penalises exporters (Economic Analytical Unit, 2001b; East Asia Analytical Unit, 1999). High inflation rapidly can make an economy's real exchange rate overvalued, also undermining exporters' capacity to compete in world markets. The negative impact of high inflation on income distribution is discussed later in this chapter.

INVESTING IN SOCIAL AND PHYSICAL INFRASTRUCTURE

Governments also must invest in their population's education and health to give them the opportunity to benefit from open economies and deliver low cost, reliable infrastructure services to ensure local producers can be internationally competitive.

Education

Public investment in education strongly influences the rate at which economies grow; it also boosts the gains from globalisation and spreads these gains more widely. One large cross country study found a one year increase in average schooling lifts economic growth rates 0.7 per cent per annum. It also found the quality of education matters; higher average student science test results were associated with higher growth (Barro, 1998). Investing in quality, broad based education gives the local population the skills to access the new technologies that trade and FDI introduce and hence secure better paid technical, managerial and professional positions. To secure FDI in technologically more advanced industries, studies find economies also need sufficient educated people to absorb and diffuse new technologies (Borensztein et al., 1998). Higher investment in basic education also allows lower skilled workers to benefit from training and employ more advanced technologies during their career, allowing their productivity and incomes to grow. The important impact of education on equity outcomes is discussed further in the following section.

Health

Investment in health and sound health policies also supports growth and increases the gains from globalisation. High adult survival rates increase incentives to save and invest in education. High infant survival rates eventually reduce fertility levels and increase parents' capacity to invest in their children's nutrition and education. Good nutrition and low disease incidence also improve learning outcomes and workers' productivity and capacity to absorb new technologies. Improved health outcomes particularly benefit growth in least developed economies, especially in tropical regions where diseases are more widespread and debilitating (Bhargava et al., 1998). It is now widely recognised that unless health authorities and politicians give high priority to eradicating HIV/AIDS, this pandemic will have an increasingly negative impact on economic growth in Africa and parts of Asia in the 2000s (World Bank, 2002c).

Physical Infrastructure

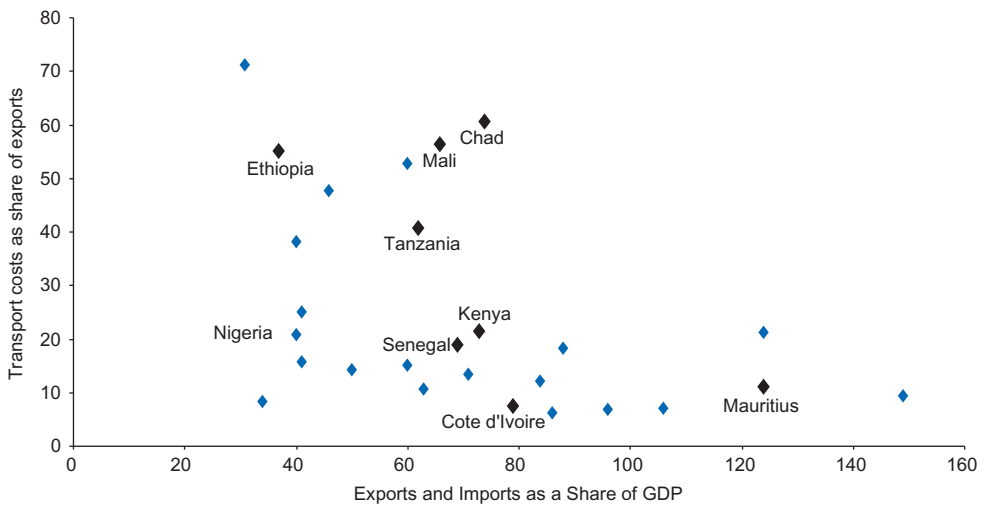
Adequate public investment in efficient, reasonable cost infrastructure increases returns from private and human capital investment, boosting economies' competitiveness and growth. In developing economies, investments in transport, electricity, water supply and telecommunications infrastructure often generate higher rates of return than other capital investment (Easterly et al., 1993; Canning et al., 1994). In the early 1990s, the World Bank estimated China's transport and other infrastructure shortages were taking one percentage point off its GDP growth rate each year (East Asia Analytical Unit, 1997). The Chinese Government responded to these shortages by making massive new investments in road, telecommunications and electricity infrastructure, removing many of these constraints. Chronic shortages of infrastructure still inhibit Indian producers' capacity to respond to the opportunities and competition of more open trade markets (Economic Analytical Unit, 2001a).

In particular, poor domestic transport provision damages many developing economies' export performance, limiting their gains from globalisation. For example, prior to the government abolishing its cargo monopolies, exporters in land locked Uganda spent 70 per cent of the value of merchandise export on transport and insurance (Yeats, 1997). On average, transport costs still absorb as much as 40 per cent of African export revenues (Figure 2.4).

Figure 2.4

Transport Costs Deter African Trade

Scatter Plot of Transport Costs as a Share of Exports and Exports and Imports as a Share of GDP



Note: Statistical analysis suggests that transport costs explain around one half of the variation in economies' share of trade in GDP.

Source: Yeats, 1997.

Increasingly, governments are encouraging private sector infrastructure investment; this is important to expand funding available for infrastructure and improve service delivery. However, breaking up integrated state owned monopolies and closely regulating any remaining natural monopoly elements is essential to ensure privatised infrastructure operates in reasonably competitive markets. This helps keep infrastructure service costs as low as possible for local producers and consumers, enabling exporters to compete in international markets (East Asia Analytical Unit, 1998).

IMPROVING EQUITY IN A GLOBALISING ECONOMY

Little evidence exists that globalising economies experience higher levels of inequality than non globalisers. In labour abundant developing economies, open trade regimes encourage specialisation in labour intensive industries which create jobs for low skilled workers, improving their living standards and overall equity outcomes.

In developed economies, most studies find technological change, which increases demand for skilled workers relative to unskilled workers, drives most increases in inequality (Cline, 1997). More open trade regimes also can reduce employment opportunities for low skilled workers in developed economies unless associated with active retraining programs for displaced workers and improving general levels of education. However, overall, technology appears to play a much more important role than trade in depressing unskilled workers' wages.⁶

In both developed and developing globalising economies, the most important policies for improving equity are providing mass education for both males and females and training. Maintaining low inflation and developing even a basic social safety net, particularly in times of rapid structural change, also improve equity outcomes.

Education Important to Equity Outcomes

Investing in education and training protects against inequality arising from technological change by enabling workers to upgrade their skills and move out of oversupplied unskilled labour categories. For example, one study found that by prioritising investment in education the ROK has minimised the deterioration in equality due to rising skilled wages (Cornia, 1999). In contrast, Brazil invests considerably less in mass education and has experienced widening inequality (Cornia, 1999).

Despite such evidence, many developing economies' investment in education has declined in recent decades. Since 1980, real per capita public spending on education has fallen by 60 per cent in Sub Saharan Africa and South Asia and by 33 per cent in Latin America (Oxfam International, 1999).⁷

⁶ For example, between 1973 and 1997, the median real weekly earnings of full time male US workers fell from US\$700 to US\$600 in constant 1997 US dollars (Sapir, 2000). One study found about 80 per cent of this decline was due to technological change that reduced the demand for unskilled labour, with competition from imports accounting for the remaining 20 per cent (Cline, 1997).

⁷ For example, South Asia now accounts for almost 25 per cent of the world's population but for only 4 per cent of its spending on education and sub Saharan Africa, with 10 per cent of the world's population, accounts for only 1 per cent of education spending.

MAKING EDUCATION A PRIORITY

While developing economies obviously can invest less in their population's education than developed ones, some low income economies achieve considerably better educational outcomes than other economies with similar per capita income. This indicates the importance of education policies. A ranking of economies' educational performance based on net enrolments, gender equity and school completion found that Sri Lanka and China ranked 40 or more places above their per capita income rankings, while Vietnam, Indonesia, Kenya and Tanzania ranked 20 or more places above their per capita income rankings. These strong outcomes reflect these economies' higher policy priority for education and in some cases strong parental commitment to their children's education. By contrast, educational outcomes in Colombia, Argentina and Brazil rank well below those in some poorer economies.

Source: Oxfam International, 1999

Building Social Safety Nets

Governments can use social safety nets to improve equity outcomes and minimise the social costs of adjusting to sudden increases in international competition. Temporary income support while undertaking retraining or education can help people move out of low skilled jobs or industries in which the economy has limited long term competitiveness.

However, excessive minimum wage provisions and social safety nets can have unintended negative impacts on low income earners. For example, in Europe, high minimum wages for low skilled workers have reduced inequality between employed skilled and low skilled workers but resulted in higher long term unemployment, particularly of low skilled workers. This increases income inequality between employed and unemployed people (Sapir, 2000).

In developing economies, with more limited financial resources, fewer governments can afford social safety nets and then usually only to deal with major crises. Nevertheless, governments have adopted a range of relatively low cost schemes including short term, targeted food price subsidies, food stamps, school feeding and micro enterprise credit (World Bank, 2002b). (See Chapter 6 – *Implications*.) Successful social safety nets target disadvantaged groups carefully, are easy and inexpensive to administer and take account of regional and ethnic disparities; they also minimise incentive distortions to avoid poverty traps (World Bank, 2002b).

Maintaining Macroeconomic Stability

Effective macroeconomic policy is vital to reducing inequality and minimising any negative impacts of globalisation on the poor. High inflation over extended periods, as occurred in Latin America in the 1980s and early 1990s, redistributes wealth from low income groups, who generally are unable to secure hedges against inflation, to high wealth groups, who are much better able to do so (Cornia, 1999). For example, in Turkey, Argentina and Mexico, repeated bouts of inflation and currency

devaluation favoured rich households that could afford to buy property or move their assets off shore, increasing inequality significantly (Birdsall, 2002). Recessions also usually threaten unskilled workers' employment more than skilled workers' (Cornia, 1999; Birdsall, 2002).

Financial crises, often caused by prematurely opening economies to short term international capital flows, on average affect poor developing economy households more than wealthy ones (Birdsall, 2002). In Latin America and Asia, most financial crisis have increased inequality (World Bank, 2002b). Most studies also show large scale taxpayer funded bailouts of banks and depositors, as occurred in the years following the 1997 Asian financial crisis and in the United States after the Savings and Loans crisis, on average redistribute income from lower to higher income groups (Birdsall, 2002).

See Appendix 2.1 for a discussion of other factors and policies that affect inequality in open developing economies.

ASSISTING ALL TO GAIN FROM GLOBALISATION

Opening to trade and investment creates significant overall benefits for populations in both developed and developing economies, but some previously protected industries or firms may have no long term future in more open trading environments. Such industries must contract their output and cut back employment while other industries in which the economy does have long term competitiveness will expand their output and workforce to take their place. When this process occurs over a number of years, existing education and training institutions, labour market mechanisms and social safety nets can be sufficient to smooth the transition. However, to ensure globalisation benefits all, if impacts occur in a short time frame or are concentrated in particular regions, governments may need to offer more tailored assistance programs, helping affected workers retrain for new jobs or move to other areas.⁸

Tariffs may protect regionally based industries that may find adjusting to a more competitive environment difficult because they are remote from other industry centres, markets and educational institutions. Targeting assistance to these communities therefore may be effective (Productivity Commission, 1999). Providing advance warning of tariff reductions also can give firms and workers more time to adjust.

⁸ Nevertheless, governments need to consider several issues when offering compensation. Compensation programs should be easily administered and accessible by potential recipients. The form of compensation should encourage recipients to move out of a disadvantaged group, for example through retraining, rather than merely providing a sum of money (Argy, 1999). For workers, retraining grants provide a superior form of assistance to cash transfers.

Equity Considerations

In certain cases, tariffs protect wealthy families who own domestic industries, so compensating these parties may work against equity objectives. For example, a few large wealthy families own most of the local manufacturing industries in several South East Asian economies (Economic Analytical Unit, 2002b). In these circumstances, compensation would better target the retraining of workers displaced by tariff reductions.

IMPLICATIONS

Efficient and transparent economic policies and institutions and international trade and investment reforms are complementary; neither can succeed in promoting higher living standards for the mass of the population without the other. Domestic policies, markets and institutions significantly influence the size and distribution of benefits economies and their populations derive from opening to global markets. Governments play a vital role in ensuring labour, capital and goods markets function effectively, in providing effective economic, regulatory and legal institutions, maintaining a stable macroeconomic environment and delivering efficient social and physical infrastructure services. Governments also are essential in promoting equity and ensuring disadvantaged groups are not left behind as incomes in globalising economies rise.

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APPENDIX 2.1

OTHER FACTORS AFFECTING EQUITY IN OPEN DEVELOPING ECONOMIES

Educational Distribution Important

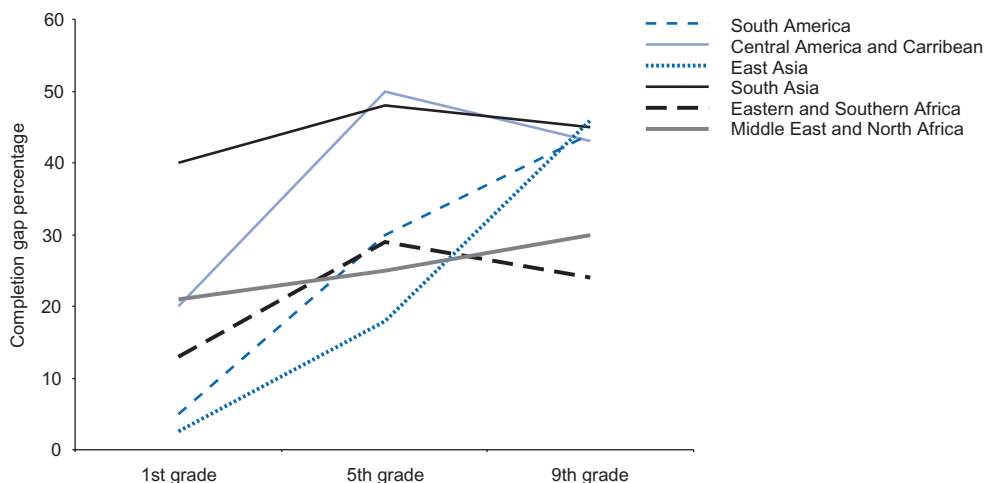
Within developing economies, unequal access to education between genders, ethnic, regional and income groups also contributes to overall inequality. For example, in Peru rural illiteracy rates are three times those of urban areas while in Pakistan, twice as many urban 10 to 14 year old children have completed school as rural children (United Nations Development Programme, 2003). Rural Zambians have considerably fewer teachers per student population than in urban areas and over 50 per cent of rural children live more than 10 kilometres from a school (United Nations Development Programme, 2003). In Brazil, the poorest 50 per cent of the population live in the northeast states, where half the children receive on average less than 4 years' schooling. In the Philippines, regional differences are considerable with only one in three children in northern Mindanao completing primary school, compared with four out of five in Central Luzon. At least partially as a result of this, poverty rates in Mindanao are twice those of Central Luzon (Oxfam International, 1999). These trends aggravate urban-rural divides that contribute significantly to national inequality trends.

In all regions, children from low income families are less likely to finish schooling than those from high income families (Figure 2.A1).

Figure 2.A1

High Income Students Complete School More Often than Low Income Students

Difference in Completion Rates between Richest 20 per cent and Poorest 40 per cent of the Population



Source: Birdsall, 1997

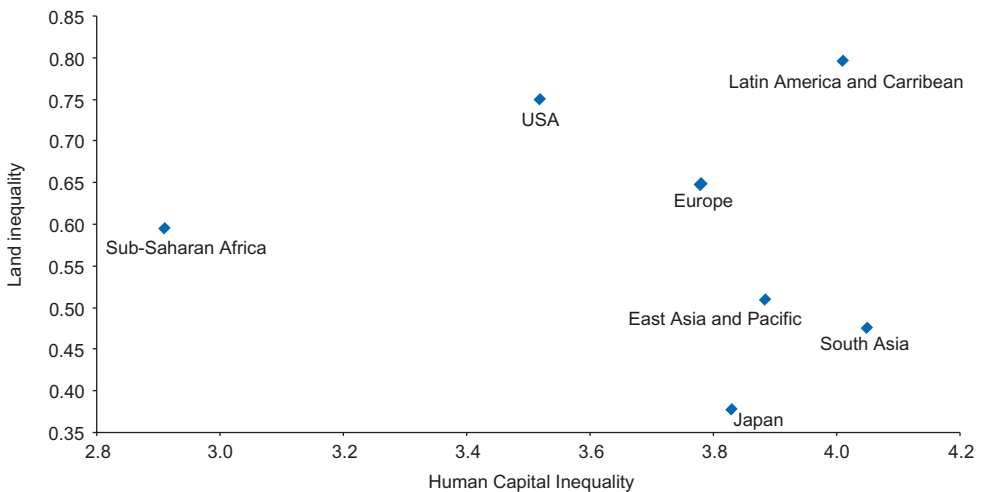
Gender inequality in accessing education also contributes to poverty. In India, female enrolment rates in secondary schools are 30 per cent below those for males. In Bangladesh, the female literacy rate for those over 15 years is 30 per cent while for males it is 52 per cent (United Nations Development Programme, 2003).

Distribution of Land and Other Assets

Unequal distribution of other assets, particularly land also contributes to national inequality through the income they generate. For example, Latin America’s land holding inequality is around one third higher than sub-Saharan Africa’s and nearly double that of East Asia and the Pacific (Figure 2.A2) (Deininger et al., 2000). By encouraging the growth of industry and services sectors, globalisation can reduce the importance of land ownership as a source of inequality.

Figure 2.A2

Asset Inequality Varies Across Regions Land and Education Inequality by Region



Notes: A higher reading on either axis means more inequality. ‘Land Inequality’ is represented by the Gini co-efficient. Its value ranges from zero, for a society where everyone owns the same assets (ie total equality) and one, for a society where one member owns all the assets (ie maximum inequality). ‘Human Capital Inequality’ is measured by the standard deviation of citizens’ years of education; a higher standard deviation means greater educational differences across citizens, and hence inequality. Both measures are weighted by population.

Europe includes Eastern Europe.

Source: Birdsall, 1997

In rural areas of developing economies, land is virtually the sole source of income and wealth generation, so defining land property rights and ensuring people can access productive land is vital to improving equity outcomes (Deininger et al., 1999). However, experiences vary regarding the impact of active land redistribution programs on inequality. *Ad hoc* expropriation generates conflict and undermines formal property rights and investment, as Zimbabwe's experience in 2001-03 shows. Several Asian economies, including Japan and the Republic of Korea used land reform as a key part of their early development strategy, significantly improving equity outcomes (United Nations Development Programme, 1999). Efficient land sales and rental markets also can overcome uneven land distribution, so long as credit and other factor markets support these (Deininger et al., 1999).

Other strategies for improving uneven asset distribution include increased education for the poor, provision of credit facilities for low income households, ensuring fair competition and promoting broader economic and political participation in rural areas.⁹ Governments need to monitor and improve the equity impacts of their allocation of social services like health and education, public goods and other infrastructure like roads and electricity and also of state asset sale and privatisation policies. For example, in Russia and parts of Eastern Europe, fire sale of public assets, sometimes in non-transparent circumstances, severely increased asset and income inequality (Deininger et al., 2000).

Promoting Rural Development

In developing economies, urban-rural income gaps are a major source of national inequality. Urban communities often enjoy strong government supported advantages over their rural counterparts, including better access to public education and health and higher per capita government spending on infrastructure (Eastwood et al., 2000).

Studies also indicate urban communities tend to gain relatively more from trade reforms. For example, most labour intensive industries, which have benefited from freer world manufactures trade in recent decades, are located in or around urban areas. However, developed economies' agricultural tariffs and subsidies constrain the growth of agricultural exports, depressing farm incomes (Economic Analytical Unit, 2003). Reflecting these biases, urban areas in developing economies generally enjoy better overall living and health standards than rural areas, and the gap has risen since the 1970s (Eastwood et al., 2000).

Successful policies governments have implemented to address rural inequality include ensuring rural producers have secure land tenure and markets where they can sell surplus produce and obtain inputs; the latter involves governments prioritising investment in rural transport infrastructure. Providing public goods and social services, particularly education and health and other infrastructure including electricity, irrigation, drinking water and telecommunications to rural areas also is crucial to overcoming rural disadvantage. Decentralising administration to the provincial level can improve

⁹ Studies indicate that in developing economies, increasing poor households' ownership of assets generates on average twice as much income as these same assets produce in wealthy households (Birdsall, 1997).

rural services but investing in administrative capacity is essential if this policy is to be effective (International Fund for Agricultural Development, 2002). Rural credit schemes are important in assisting rural households and businesses invest in new technologies and increase their productivity. Finally, maintaining low inflation also is important for rural areas. In Brazil, urban-rural inequality declined over the 1990s largely due to reduced inflation which had relatively disadvantaged rural households (Ferreira et al., 1999).

Studies show improved productivity growth in smallholder agriculture sharply reduced rural poverty in Indonesia and Malaysia in the 1970s, as it did in Japan, the Republic of Korea and Taiwan in the 1950s and 1960s (International Fund for Agricultural Development, 2002). In China, rising grain yields, a relatively equal distribution of land among households, rising producer prices, better access to free markets and greater use of market prices for agricultural products also reduced rural poverty between 1978 and 1984, though the rural-urban divide increased again in the 1990s as agricultural product prices fell compared with industrial product prices (International Fund for Agricultural Development, 2002).

GRAMEEN BANK SUCCESSFUL RURAL FINANCER

Bangladesh's Grameen Bank was the first important model for micro-financing aimed specifically at the credit needs of small farmers and other producers in rural areas. Similar institutions now operate in many Asian, African and Latin American economies. Established in 1976 by economics professor Dr. Mohammed Yunus, the Grameen Bank provides small short term loans to groups of prospective village entrepreneurs, with all group members guaranteeing the loan. Loans aim to encourage self reliance, boost incomes and improve human development. Access to future credit is contingent on successful repayment of initial loans. Peer monitoring and promises of subsequent larger loans provide strong incentives for repayment and generate very low default rates; Grameen enjoys a remarkable 98 per cent loan repayment rate. Today the bank's services reach an estimated 38 000 villages throughout rural Bangladesh, benefiting some two million families.

Source: Osman, 1999.

GETTING INTERNATIONAL POLICIES RIGHT

KEY POINTS

- Despite 50 years of international trade and investment liberalisation, world markets are still far from free. Developing economies still often receive unfair treatment in the global trading system, preventing them maximising their opportunities to grow and develop. Efficient agricultural producers like Australia also face many market barriers.
- Developed economy trade barriers against agricultural products and labour intensive manufactures like textiles, clothing and footwear particularly discriminate against developing economy exports and efficient developed agricultural producers like Australia. If developed economies lowered their trade barriers to developing economy imports, developing economies would gain more income than from all current aid programs. Developed and developing economies also would benefit from lowering their own trade barriers.
- The recently launched Doha Round commits World Trade Organization, WTO, members to prioritising market access and other issues of importance to developing economies. However, many developed economies are resisting removing their agricultural trade barriers and subsidies creating a major impediment to developing economies gaining more from globalisation.
- To benefit fully from globalisation, economies also recognise the need to cooperate in a range of other fields, including strengthening international financial architecture, combating international anti-competitive behaviour and transnational security concerns, including the spread of communicable diseases.

TRADE BARRIERS DAMAGE EVERYONE

Trade barriers against labour intensive manufactures and agricultural products hinder developing economy export strategies, reducing the options available to developing economies. The WTO’s new Doha Round of trade liberalisation is committed to improving developing economy market access, especially through reducing high barriers and subsidies which distort agricultural trade. The Doha Round also will focus on other developing economy issues such as access to generic medicines.

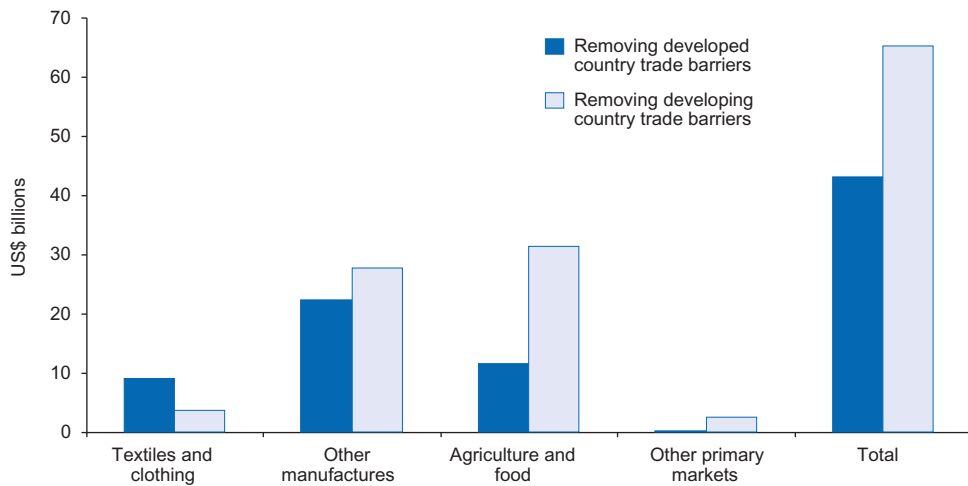
The Costs of Global Trade Barriers

Despite 50 years of trade reforms, remaining global trade barriers still impose considerable costs on developing and developed economies alike. International trade barriers hinder developing economies specialising in and exporting products they produce most competitively and reaping the maximum gains from free trade. By removing all developed economy barriers to developing economy imports, developing economies could gain over US\$40 billion extra a year (Figure 3.1) (World Bank, 2002a).¹ Adding in gains from removing developed economy subsidies, total potential gains would exceed international aid flows to developing economies.

Figure 3.1

Significant Developing Economy Gains from Trade Reform

Minimum Potential Annual Gains for Developing Economies from Removing Developed and Developing Economy Trade Barriers



Note: This estimate is the lower bound of direct trade reform gains as it assumes developing economies have already received the benefits from Uruguay Round commitments to remove textiles and clothing quotas, which will not be phased in until 2005.

Source: World Bank, 2002a

¹ This estimate is the lower bound of actual benefits because it excludes efficiency gains developing economies would achieve from operating at larger production scales and using more advanced technologies they could afford if they increased their market share; it also excludes the benefits from services liberalisation. These estimates provide an income equivalent of the welfare gains, rather than an estimate of the rise in GDP.

Developing economies' trade policies also damage one another. While their markets are smaller, developing economies on average impose up to three times higher trade barriers than developed economies. Hence developing economies could increase their welfare by over US\$65 billion if they liberalised their own trade regimes (Figure 3.1) (Yeats, 1997; World Bank, 2002a).

Developed economies like the EU, the United States and Japan finance huge domestic agricultural production and export subsidy schemes that depress world agricultural prices by an estimated 12 per cent (United States Department of Agriculture, 2001).² In 2001, 12 per cent of African agriculture was worth US\$7.1 billion, only slightly lower than bilateral aid flows to Africa of US\$8.3 billion (Economic Analytical Unit, 2003). These subsidies significantly undermine developing economies' agricultural export income. When subsidised products are dumped on international markets, they also disrupt developing economies' domestic agricultural markets and third economy export markets.

Subsidised agricultural products can swamp developing economy markets when they open their own markets in the absence of international disciplines. For example, after opening the Jamaican dairy market to competition in the early 1990s, shiploads of subsidised milk powder from Europe severely damaged Jamaica's dairy farmers. Domestic producers now meet less than one fifth of domestic consumption, impacting heavily on Jamaica's mainly small scale operators (Oxfam International, 2002a). Support for US cotton farmers has virtually wiped out Mali's efficient cotton industry, sending many farmers into poverty (Oxfam International, 2002b). Mainly for this reason, many developing economies retain high barriers to agricultural imports, pushing up food prices and undermining potential farm efficiency gains (Economic Analytical Unit, 2003).

AGRICULTURAL PROTECTION IN DEVELOPED ECONOMIES

Agricultural policies in OECD economies cost consumers and taxpayers over US\$300 billion every year. Farmers receive more than one third of their incomes from government programs and the value of total agricultural support in OECD economies is more than five times higher than total overseas development assistance and double the value of developing country agricultural exports. By comparison with other developed economies, Australia's support for its farmers is negligible.

Source: OECD, 2001.

² Most developed economies pay farm subsidies on the basis of production volumes so they artificially encourage farmers to produce more, increasing world supply and depressing prices.

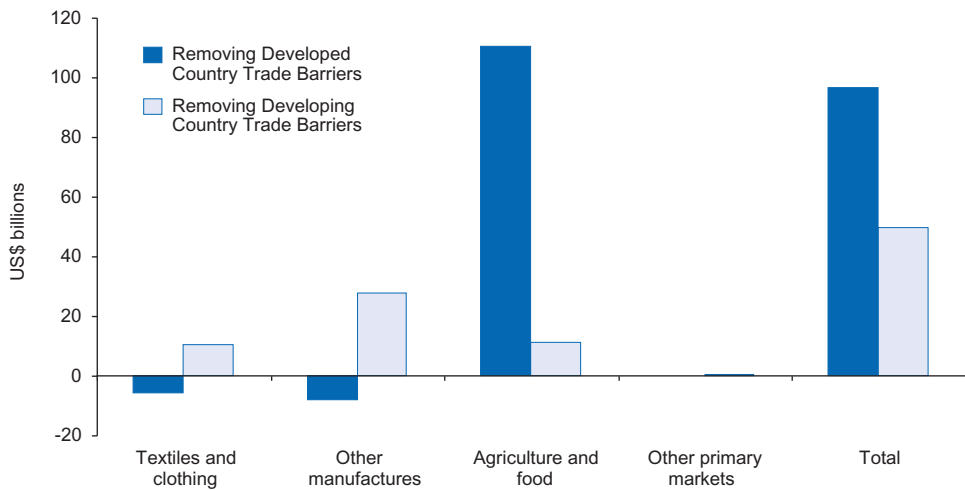
Trade Barriers Also Cost Developed Economies

Developed economies would gain even more than developing economies from reducing their own trade barriers (Figure 3.2) (World Bank, 2002a). In particular, removing agricultural protection would generate US\$111 billion per year in additional welfare for developed economies. Their consumers could buy lower cost agricultural products and increase their spending on other products and their producers could source agricultural inputs more cheaply (World Bank, 2002a). While developed economies would lose marginally from removing trade barriers to their own manufacturing sectors, developing economy gains would more than offset these losses (Figures 3.1 and 3.2).

Figure 3.2

Developed Economies Gain Most from Agricultural Trade Reform

Minimum Potential Annual Gains for Developed Economies from Removing Developed and Developing Economy Trade Barriers



Note: These figures are lower bound estimates of the impacts of liberalisation as they assume developed economies have implemented their Uruguay Round commitments, ignore dynamic and scale effects and do not include services trade liberalisation (World Bank, 2002a).

Source: World Bank, 2002a.

THE DOHA ROUND

In November 2001, the WTO's Doha Round of global trade negotiations commenced, with members agreeing to conclude negotiations by 1 January 2005. The agenda aims to address outstanding matters left from the Uruguay Round, including improving market access for all agricultural products, phasing out all forms of export subsidies and reducing farm production supports that distort trade (World Trade Organization, 2003). The Doha Declaration recognises special and differential treatment for developing economies will be an integral part of all negotiations. Negotiations also will review developed economy anti-dumping laws that hamper developing economy exports and consider how intellectual property rights and environmental issues impact on developing economies. Appendix 3.1 gives a discussion of other Doha Round issues.

CAIRNS GROUP LEADS ON AGRICULTURAL REFORMS

Australia chairs the Cairns Group of agricultural exporting nations, which aims to achieve open and fair international markets for agricultural goods. Established in 1986, the Cairns Group plays a major role in influencing WTO outcomes on agricultural trade issues and made a significant contribution to establishing an agricultural trade reform framework for the Doha Round. At its twenty fourth Ministerial Meeting in Bolivia in October 2002, Cairns Group members highlighted fundamental reform of world agricultural trade as a key to achieving the Doha Round's development objectives. Ministers also discussed how the Doha Round can meet the needs of developing economies and how developing economies and the Cairns Group can cooperate to achieve common negotiating objectives. Of the Cairns Group's 17 members, 14 are developing or middle income economies; its only developed economy members are Australia, New Zealand and Canada. Considerable scope exists for closer cooperation between the Cairns Group and other agricultural exporting developing economies, particularly China, India and African economies.

Source: Department of Foreign Affairs and Trade, 2002; Cairns Group, 2002.

PREFERENTIAL MARKET ACCESS FOR LESS DEVELOPED ECONOMIES

Instead of providing free market access for developing economies under multilateral or regional trade agreements, many developed economies increasingly offer preferential treatment for exports from developing or least developed economies. However, these schemes are a poor substitute for most favoured nation liberalisation. Preference schemes do not cover all goods and often lock poor economies into producing only those items that attract concessions, which generally are lower value added products. They also can inhibit developing economies from undertaking their own trade liberalisation, hampering their growth (International Monetary Fund, 2002; Economic Analytical

Unit, 2003). Furthermore, when developing economies start successfully penetrating their markets and displacing local producers, developed economies can withdraw such concessions, creating serious losses to developing economy producers in these sectors (International Monetary Fund, 2002).³

EU DEVELOPING ECONOMY PREFERENCES

The EU's Generalised System of Preferences offers developing economies preferential tariff access to the EU market. However, this scheme generally has not helped African, Caribbean and Pacific economies increase their share of EU imports. China benefits most from the EU's Generalised System of Preferences Scheme, with a utilisation rate of over 70 per cent, followed by India. Hence, while the new Doha Round aims to lower all EU tariffs, undermining the advantages these conventions confer, analysis indicates the losses to economies receiving preferences would be small, at around 0.3 per cent of exports in the case of Sub Saharan Africa, particularly compared to the benefits of more open markets.

Source: United Nations Conference on Trade and Development, 1996.

GLOBAL ECONOMIC COOPERATION

Keeping and expanding the gains of globalisation also requires ongoing cooperation on many global governance issues. Many activities that economies and companies undertake have beneficial or adverse transnational impacts that governments can control only through international cooperation. Major global economic cooperation priorities include improving international financial architecture, cooperating on international investment and competition issues and controlling communicable diseases (World Bank, 2001). In the past decade, through multilateral organisations and agreements, the global community has begun tackling international financial architecture and investment issues. In other areas, however, including combating abuses of global market power, international cooperation is at an early stage.

Strengthening International Financial Architecture

As the 1997 Asian financial crisis demonstrated, the international financial system is increasingly interdependent; events in one market rapidly can affect others. The costs of a single institution failing are much greater than the loss of its private capital, as it can lead to a loss of confidence in otherwise sound institutions, even triggering their collapse. Developing economies which are open to foreign capital flows but do not have sound domestic regulatory regimes are particularly vulnerable.⁴

³ For example, South African farmers formed a cooperative to grow and can pears which sold successfully in the US market. However, the United States then withdrew this preferential access, seriously damaging the cooperative's viability (Economic Analytical Unit, 2003).

⁴ Because financial markets are highly liquid and the cost of undertaking transactions is relatively low, the volume of international flows of funds can change suddenly, shifting exchange and interest rates rapidly, affecting economies. Furthermore, changes in market sentiment can quickly undermine confidence in a group of economies.

Since they were established soon after World War II, the International Monetary Fund and to a lesser extent the World Bank have played a central role in helping maintain international financial stability. In 1999, the International Monetary Fund and World Bank commenced the Review of Standards and Codes to identify weaknesses in member economies' regulatory arrangements which could contribute to economic and financial instability. This initiative is designed to foster increased market efficiency and discipline and ultimately to contribute to a more robust and less crisis prone global economy. International standards in a range of regulatory, corporate governance and macroeconomic data areas provide a benchmark to help member economies identify vulnerability and guide policy reform. Hence the program aims to increase transparency about global economic governance standards for markets and encourage governments to adhere to core international codes (International Monetary Fund, 2003).

In 1999, 11 major economies including Australia also convened the Financial Stability Forum to promote international financial stability through information exchange and co-operation in financial supervision and surveillance. The forum regularly brings together national authorities responsible for financial stability in international financial institutions, sector-specific international regulatory and supervisory groups and committees of central bank experts. The Financial Stability Forum seeks to coordinate the efforts of these various bodies to promote international financial stability, improve market functioning and reduce system wide risk in financial markets (East Asia Analytical Unit, 1999). The Financial Stability Forum also coordinates with other agencies including the International Monetary Fund to offer recommendations to develop effective bank deposit guarantee schemes, identify financial sectors at risk of instability, enhance securities regulators' information exchange and more closely involve the private sector in combating financial crises and financial market volatility (Financial Stability Forum, 2002).

Competition Rules

While most developed and some developing economies enforce domestic competition policies which prohibit anti-competitive behaviour by firms, no international agreement enforces competition internationally. In 1996, a WTO Working Group on the Interaction between Trade and Competition Policy was created to explore and analyse the link between competition and trade (Center for International Development, 2002). In 2003, in the context of the Doha Round, the working group examined a range of competition policy issues including provisions for export cartels and the need to support developing economy capacity building in regulating competition.

INTERNATIONAL CARTELS AND OPEN MARKETS

In the limited number of industries dominated by international cartels, opening to FDI can introduce such cartels to the domestic economy. This can undermine the position of local firms without delivering benefits to consumers. For example, the four largest international cement firms now dominate some developing economy cement industries, pushing up prices to domestic consumers and construction firms. Also, international shipping companies are estimated to use their market power to inflate shipping tariffs by around 25 per cent (Fink et al., 2002). Use of market power also may occur in some international agricultural markets, such as coffee beans, where some analysts claim a few large coffee bean purchasers can depress prices offered to small scale exporters, most of whom are in developing economies (Sorby, 2002).

Tackling Global Health Issues

The greater movement of people as the world globalises has increased the rate at which communicable disease spreads across borders. The incidence of many serious diseases like malaria, tuberculosis and HIV/AIDS and now recently SARS is on the rise, increasing governments' need to co-ordinate their efforts to combat them. In particular, the future growth of many African economies is under serious threat if they cannot contain the HIV/AIDS pandemic (World Bank, 2002b).⁵ Since the mid 1990s, UNAIDS has coordinated the global response to the AIDS crisis. Since then, the World Bank has initiated a regional AIDS prevention program, the Multi-Economy AIDS program, the first stage of which covers Ethiopia and Kenya (World Bank, 2002b). Similar international coordination efforts are needed in a range of areas affecting international health, including vaccinating against common childhood and communicable diseases, spraying for malaria carrying mosquitoes and improving water quality.

IMPLICATIONS

The international environment in which developing and developed economies trade and invest is crucial to determining populations' gains from globalisation. Through the World Trade Organization and the International Monetary Fund, the world's governments have achieved much since the end of WWII, building relatively freer international markets for goods, services and capital which all economies can access, regardless of their size, wealth or power. However, much remains to be done to ensure developing and developed economies can access all international markets at fair prices and conditions. Reducing developed and developing economy trade and investment barriers and trade distorting subsidies is crucial to this objective. Managing global issues like international financial contagion, anti-competitive behaviour and communicable diseases also increasingly influences economies' ability to prosper in the global market place.

⁵ Africa includes the top 19 economies for HIV/AIDS prevalence in the world. In 2000, the World Bank estimated 25.3 million Africans were living with AIDS, 3.8 million of whom were infected with HIV during that year. About 12 million African children have been orphaned by AIDS (World Bank, 2002b).

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APPENDIX 3.1

OTHER DOHA ROUND ISSUES AND DEVELOPING ECONOMIES

As well as covering trade access in agriculture, the Doha Declaration, which sets the framework for the new trade negotiation round, indicates the round will review how non-trade issues, intellectual property rights and environmental issues impact on developing economies. Offering appropriate technical assistance to help developing economies participate fully in negotiations also is an integral part of the Doha Round.

Negotiating on Non-Trade Issues

Developing economies often oppose including investment, competition and government procurement, known as the Singapore Issues, in liberalisation negotiations.⁶ This is partly because many developing economies feel they lack the negotiating power and resources to participate competently in such talks. Some also believe they cannot commit to implementing such agreements and fear other members may retaliate through trade sanctions if they fail (Panagariya, 2001). With respect to investment, some developing economy governments remain protective of their infant services sectors, though the experience of successful developing economies does not justify this position. Responding to these concerns, WTO members only agreed to start to address Singapore Issues in the Doha Round.

Intellectual Property

Some developing economies believe the trade related intellectual property agreement, TRIPS, seeks to protect returns to product innovators who mainly reside in developed economies, raising the costs of new technologies to developing economies. Developing economies feel this concern most keenly regarding pharmaceuticals, particularly those needed to treat serious diseases affecting developing economies including HIV/AIDS and tuberculosis. Doha negotiations are seeking to address this problem through the *TRIPS Agreement on Public Health*, which in situations of 'national emergency or other circumstances of extreme urgency' gives member governments the right to grant domestic producers a license to produce otherwise protected products (Vaile, 2002; Panagariya, 2001). This agreement would require governments to seek patent holder authorisation on reasonable commercial terms, although in extreme circumstances this requirement also may be waived.

The Doha negotiating agenda aimed to resolve the issue of access to pharmaceuticals for developing economies by the end of 2002. Unfortunately, WTO members could not agree on which diseases the TRIPS agreement should cover; developing economy members wanted a large and flexibly defined list. It is important for the viability of the Doha Round that WTO members reach an acceptable agreement on this issue.

⁶ These issues are so called as they were first raised in the Singapore Ministerial Declaration in 1996.

Environmental Issues

Efforts by some developed economies to include environmental matters in Doha Round negotiations concern developing economies as they fear some developed economies could use certain environmental concerns as a justification to bar their exports. (See Chapter 1 – *Globalisation Works*.) The EU succeeded in including environmental issues in the Doha negotiations, although members committed only to examine how WTO rules relate to multilateral environmental agreements and to reduce tariffs and other barriers to trade in environmental goods and services (Panagariya, 2001).

WTO Technical Assistance

Participating fully in the WTO negotiations is very demanding for developing member economies; increasingly developed economies including Australia are helping them meet this challenge. More than 75 per cent of WTO members are developing economies, of which 30 are least developed economies. Many have limited representation in Geneva and consequent difficulties in coping with the broad Doha negotiating agenda (Blackhurst et al., 2000).

At Doha, Ministers confirmed technical cooperation and capacity building are core elements of the development dimension of the multilateral trading system. Since 1998, the number of WTO technical assistance activities has grown by 66 percent as developing member governments have requested increasing amounts of assistance (World Trade Organization, 2003).⁷ Areas of assistance include developing trade policy, streamlining customs and quarantine procedures, strengthening taxation systems, reforming tariff regimes, promoting trade and tourism and formulating investment policy (World Trade Organization, 2003). As part of its governance sector assistance, Australia has an active program of technical assistance, cooperation and policy dialogue with developing economies aimed at strengthening their capacity to participate in global and regional trading arrangements and take advantage of new trade opportunities.

⁷ WTO technical assistance is designed to assist developing economies and low-income economies in transition to adjust to WTO rules and disciplines, implement obligations and exercise the rights of membership, including drawing on the benefits of an open, rules-based multilateral trading system (World Trade Organization, 2003).

GLOBALISATION TRANSFORMS AUSTRALIA

KEY POINTS

- Since the early 1980s, Australia has gained significantly from internationalising its economy and implementing microeconomic reforms, increasing its income, employment and living standards growth.
- By the second half of the 1990s, Australia's productivity grew by around 3 per cent per year, 40 per cent faster than in the 1970s and 1980s.
- In 2001-02, Australians were around 55 per cent better off than in 1979-80, with real GDP per capita of around A\$36 000 compared with around A\$23 000, both in 2001-02 dollars.
- Australia internationalised its economy in tandem with comprehensive domestic market and institutional reforms; these transformed Australia from an inward looking, under performing economy to an outward oriented and more dynamic economy.
- Australians now strongly support free trade and globalisation. Investment in education and training and assisting workers to manage structural change helps maintain social equity.
- Australia is a good example of how strong domestic policies and institutions help a society maximise the gains from globalisation.

AUSTRALIA GLOBALISES

Since undertaking trade reforms in the 1980s and 1990s, Australia has become one of the most open economies in the world. Combined with other domestic reforms this has driven faster growth in output and living standards.

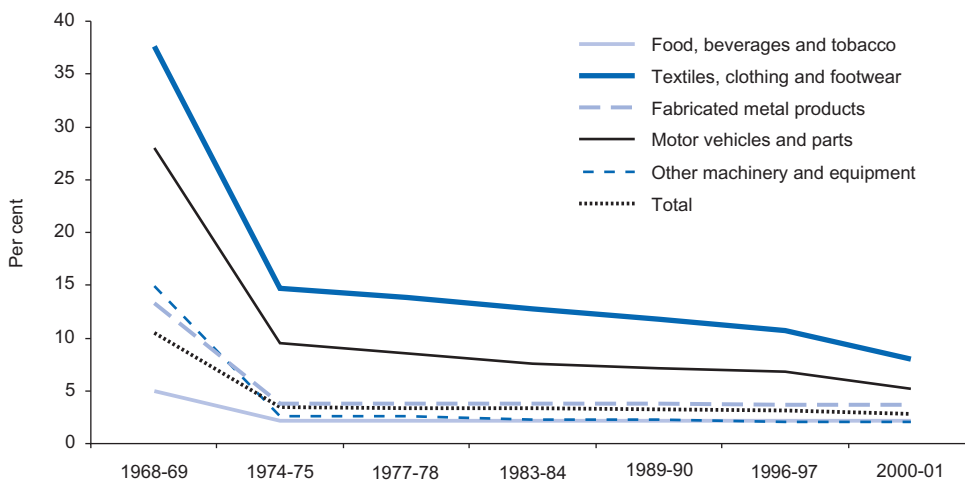
Trade

Since the 1970s, Australia has reduced tariffs dramatically. By 2000-01, average effective rates of manufacturing assistance had fallen to 5 per cent from a high of 22 per cent in 1984-85 (Industry Commission, 1995; Productivity Commission, 2001).¹ Rates of assistance remain significant only in the car and textiles, clothing and footwear industries. Outside these sectors, average levels of manufacturing assistance are very low (Figure 4.1).² By 2001, Australia's applied tariffs were comparable to the most dynamic developed economies and higher than only a few economies.

Figure 4.1

Industry Assistance Falling

Selected Australian Manufacturing Rates of Assistance, 1968-69 to 2000-01, Per cent



Notes: Assistance rates measure the rates of protection tariffs and certain non-tariff measures provide. Total assistance is the weighted average of assistance rates across industries, with weights equalling each industry's share.

Source: Productivity Commission, 2001.

¹ Effective rates of assistance measures include the impact of trade barriers, budgetary assistance and other assistance that raise the return to protected producers; they show the percentage increase in returns that assistance delivers.

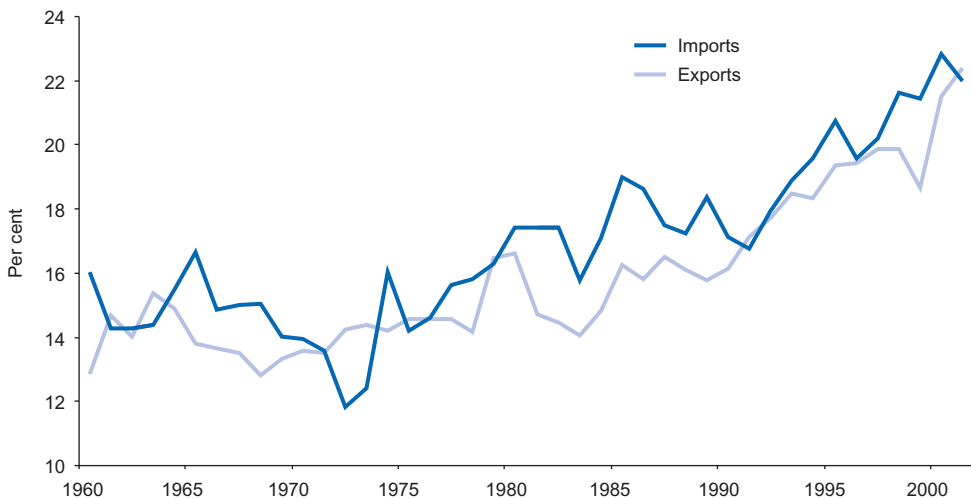
² In 2000-01, the effective rate of assistance for cars was 14 per cent and for textiles, clothing and footwear was 23 per cent, down from 165 per cent and 68 per cent respectively in 1984-85. For all other manufacturing, effective rates of protection were between -1 and 6 per cent.

With tariffs falling through the 1980s and 1990s, Australia's trade increased dramatically. Imports and exports as a share of gross domestic product, GDP, almost doubled to over 22 per cent by 2001 (Figure 4.2). While lower tariffs expanded imports, increasingly competitive Australian producers increased exports at the same pace.

Figure 4.2

Trade Growing Strongly

Exports and Imports Rising as Share of GDP, 1960-2001, Per cent



Source: Australian Bureau of Statistics, 2002a.

Foreign Direct Investment

From the early 1980s, Australia also liberalised its foreign direct investment, FDI, regime and now has one of the region's most liberal. These reforms attracted large FDI inflows, increasing overall investment, competition and growth (Figure 4.3). Limited restrictions on FDI remain in aviation, media and established residential real estate. While the *Foreign Acquisitions and Takeovers Act 1975* empowers the Federal Government to examine FDI proposals over A\$20 million, it can only reject proposals it finds are contrary to the 'national interest'. Since the mid 1980s, when the national interest test replaced the net economic benefits test, considerably less than one per cent of foreign investment proposals in the non-sensitive sectors failed to meet this criterion. At the same time, Australian investment abroad has increased as other countries liberalised their investment regimes and Australian firms sought to expand in areas where they had a competitive advantage (Figure 4.3).

Other Capital Flows

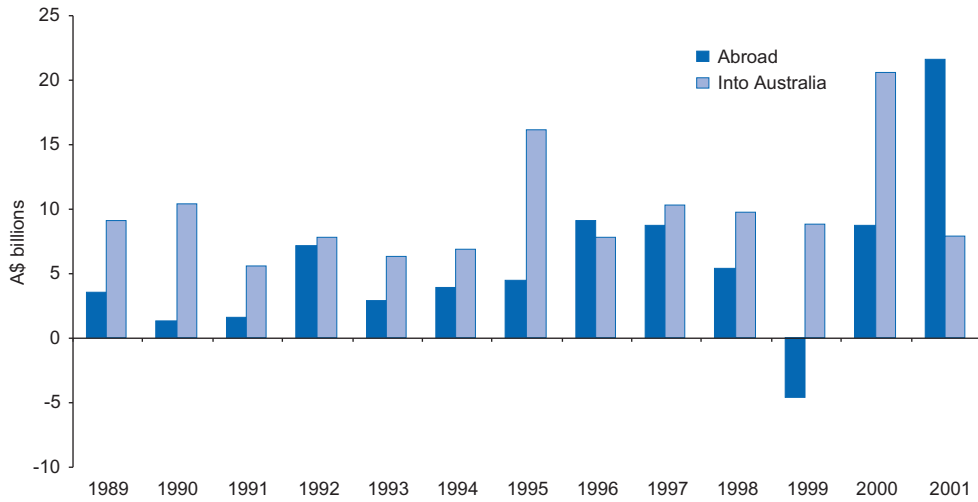
After opening its capital account in 1983, Australia also attracted increasing inflows of international investment in local shares and debt, expanding total capital inflows (Figure 4.4).³

³ In 1981, the Committee of Inquiry into the Australian Financial System, the Campbell Inquiry, recommended liberalising the banking system and exchange rate to promote financial system efficiency, competitiveness and stability; this inquiry resulted in the government abolishing capital outflow controls and abandoning the pegged exchange rate.

Figure 4.3

FDI Rebounding

Australia's FDI Inflows and Outflows, 1989-2001, A\$ billion

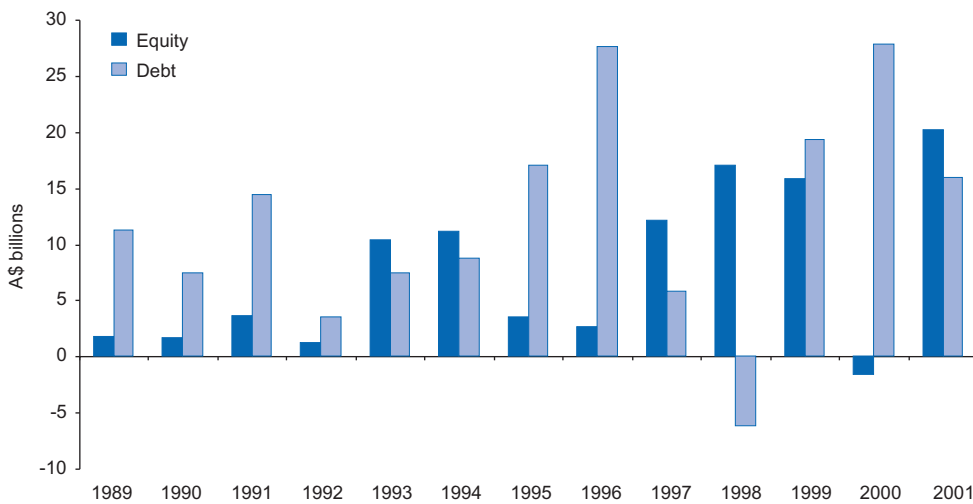


Source: Australian Bureau of Statistics, 2002a.

Figure 4.4

Equity and Borrowing Inflows also Strong

Equity Inflows and International Borrowing by Australia, 1989-2001, A\$ billion



Source: Australian Bureau of Statistics, 2002a.

MAKING GLOBALISATION WORK FOR AUSTRALIA

At the same time as Australia opened its markets to goods and capital, it embarked on a broad program of microeconomic reform that helped consumers, firms and workers respond more flexibly to global markets.

AUSTRALIA BEFORE REFORM

Throughout much of the twentieth century, high and stable agricultural and resource prices sustained Australia's rapid growth, encouraging successive Australian governments to develop a domestically oriented manufacturing sector and redistribute the gains from export earnings. Policy strategies included protecting industries from imports, centralising wage determination and establishing state owned enterprises in infrastructure and many other industries.

In 1965, the Vernon Committee began a series of official reports highlighting the costs of these policies and the structural problems they created. These included poor work practices and labour relations, a proliferation of fragmented, domestically focused industries using out of date technology, poor investment decisions throughout the economy, especially involving government and hence a weak manufacturing sector, increasing dependence on agricultural and resource exports. The reports argued these structural problems depressed Australia's productivity performance and income growth. Consequently, they concluded Australia lacked the structure, flexibility and entrepreneurial culture to meet the challenges of integrating with the world economy and benefiting from rapid technological change. As a result, subsequent governments accepted the need for major reforms.

Source: Productivity Commission, 1999a.

Reforming Domestic Markets and Institutions

During the 1980s, Australia's major economic reforms included deregulating financial markets and freeing the pegged exchange rate; in the 1990s, Australian governments reformed labour markets, taxation and national competition policies. Australian Commonwealth and state governments also undertook large privatisation programs. Deregulating the labour and financial markets allowed firms to adjust their employment and investment levels more quickly to adapt to international competition and opportunities. These reforms also helped workers move more rapidly into new employment, significantly reducing unemployment rates.

Australia's reforms are ongoing. For example, the 1997 Wallis inquiry recommended major changes to the regulation of the Australian financial system. The Australian Government subsequently divided responsibility between two new regulators: the Australian Prudential Regulatory Authority and Australian Securities and Investments Commission.⁴ In corporate regulation, the Corporate Law

⁴ It also introduced a harmonised licensing, conduct and disclosure framework governing financial service providers, financial markets and financial products. The new licensing provisions contain a number of provisions that are intended to facilitate cross-border activity.

Economic Reform Program resolved legal inconsistencies arising from Australia's federal system of government. It also modernised regulation of financial reporting and financial markets, corporate governance, takeovers, directors' duties, fundraising and investment products to enhance transparency and accountability (Australian Treasury, 1999).⁵

Appendix 4.1 provides more details of Australia's market and institutional reforms.

AUSTRALIANS POSITIVE ABOUT TRADE

Three decades of trade reforms have made Australians optimistic about the role trade plays in their lives. In 2002, 85 per cent of Australians believed exports made a major contribution to the economy, up from 73 per cent in 2001; 46 per cent of respondents believed exports made a direct contribution to their standards of living, up from 34 per cent in 2001. Significantly, even more people, 89 per cent, believed imports increased consumer choice and 73 per cent believed they kept prices and manufacturers competitive. Close to half of all respondents thought tariffs were either too high or at appropriate levels.

Source: Newspoll, 2002.

Sequencing Reforms

Australia generally did not embark on a predetermined sequence of reforms according to a 'blueprint'; rather governments undertook reforms as events required and political factors allowed. However, reform in one area, particularly lower trade barriers and floating of the exchange rate, often increased pressure to reform other areas. As reform progressed and delivered benefits in terms of higher living standards and lower unemployment, community support increased, making new reforms easier to achieve.

At times, the sequence of reforms led to frictions. For example, financial deregulation occurred before authorities began strengthening corporate governance and bank supervision standards, contributing in the 1980s to corporate failures and pressures on some banks. Nevertheless, Australia's experience from two decades of reform has been overwhelmingly positive.

IMPACT ON THE ECONOMY

Over the past two decades, opening to world markets and other reforms markedly altered how Australian businesses operate, forcing some to transform quickly to compete. The most important changes were improved management practices, greater specialisation and more rapid technological uptake.

⁵ Further reforms have been proposed to strengthen corporate accountability and reporting including audit independence. Proposals will see audit standards brought under the umbrella of government oversight with auditing standards given the force of law (Australian Treasury, 2002a).

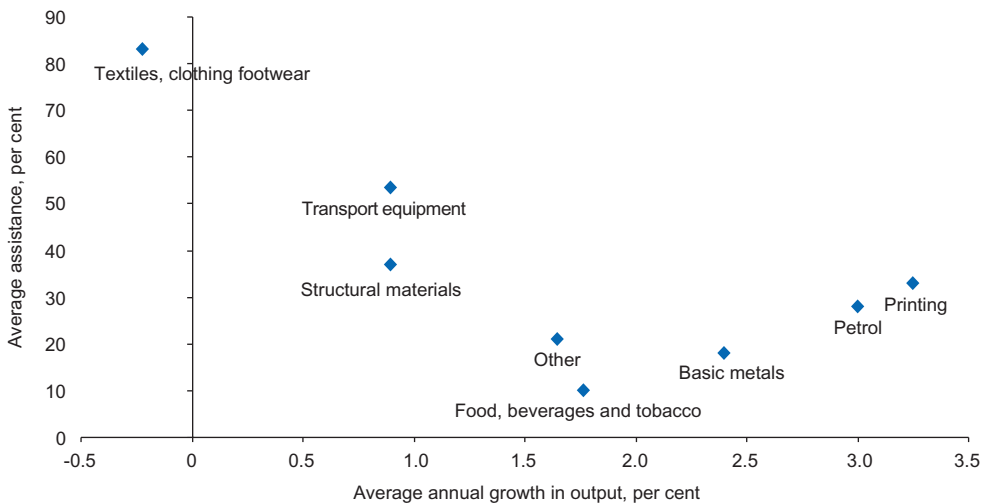
Lower Tariffs Associated with Strong Industry Growth

Lower trade barriers helped increase the level of competition Australian industries face, contributing to output growth (Figure 4.5). Falling prices also increased demand from consumers and other producers. Hence, a study of Australian industry from the 1960s to the 1990s found a 1 per cent decrease in industry protection led to a permanent 0.15 per cent increase in industry output (Chand et al., 1998).

Figure 4.5

Lower Trade Barriers Expand Industry Output

Scatter Plot of Average Levels of Assistance and Average Annual Output Growth, 1968-69 to 1994-95, Selected Industries, Per cent



Source: Chand et al., 1998.

Productivity, GDP Per capita Growing Faster

Australia's productivity growth ranking amongst developed countries rose sharply in the 1990s, outpacing nearly all other developed countries (Productivity Commission, 1999a).⁶ In the late 1980s, Australia's tariff reductions increased manufacturing productivity growth to more than twice the rate achieved in the rest of the economy (Productivity Commission, 1999a).⁷ Domestic reforms also directly lifted other sectors' productivity growth. For example, infrastructure utilities' corporatisation and privatisation improved their productivity growth to around 6 per cent per year in the late 1980s and early 1990s.

⁶ In the 1990s, growth in output per employed person, labour productivity, averaged around 3 per cent per year, compared with 2.2 per cent from the mid 1960s to the early 1990s. Investment productivity growth increased by even more, growing at 0.8 per cent per year in the 1990s after declining by an average 1.3 per cent between the mid 1960s and the early 1990s (Productivity Commission, 1999a). Normally, countries' growth rates slow as they reach higher income levels, making this achievement even more impressive.

⁷ Within manufacturing, productivity growth in the white goods industry increased from 5.3 per cent per year in the 1970s when high tariffs and quotas protected the industry to 8.3 per cent per year in the 1980s (Productivity Commission, 1999b). By contrast, the textiles, clothing and footwear industries which continue to receive high but falling protection, achieved much lower productivity increases (Productivity Commission, 1999b).

Higher productivity growth allowed Australia’s GDP per capita to grow more strongly in the 1990s than in all previous decades except the 1960s (Figure 4.6). Higher GDP per capita means the economy is producing more goods and services for each Australian, increasing average living standards.

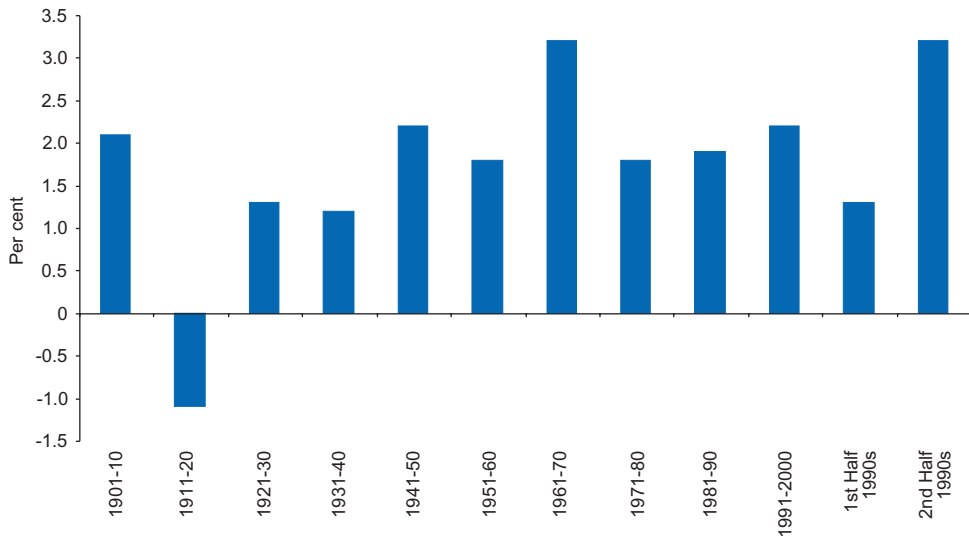
New Management Techniques

Facing greater domestic and foreign competition, Australian firms have upgraded management practices and workplace arrangements. To improve competitiveness, many firms now benchmark their performance against leading global firms and use production processes that conform to international quality standards (Productivity Commission, 1999a). For example, the automotive industry has adopted ‘lean production’ in assembly processes and more carefully manages inventory and quality, forcing change on component suppliers. Increasingly, firms, governments and public utilities contract out non-core activities to improve efficiency. In over half of Australian workplaces with more than 20 employees, workplace agreements link pay to employee performance (Productivity Commission, 1999b).

Figure 4.6

Reaping the Benefits of Reform

Australia’s GDP Growth Per capita, Decade Averages, 1901-2000, Per cent



Source: Australian Treasury, 2002b.

Increased Specialisation

Greater market discipline also forces firms to rethink their areas of expertise. From the mid 1980s, trade between firms within a given industry rose sharply, indicating firms were specialising more and relying on others to supply inputs they once produced themselves (Productivity Commission, 1999a).⁸

Greater Technology Uptake

Since Australia reduced its trade barriers and reformed labour and financial markets, firms also have invested more in technology. The proportion of manufacturing businesses with 10 or more employees using advanced technologies increased from 33 per cent in 1988 to 44 per cent in 1997 and expenditure on foreign capital goods and research and development has increased strongly (Productivity Commission, 1999a). In the early 1990s, a 900 firm survey found international competitive pressure was the major reason firms gave for increasing their research and development spending (Bureau of Industry Economics, 1993).

Although Australia is a net importer of information technology, it has adopted these technologies aggressively, generating major efficiency gains for business and consumers. Australia's use of computer technology is among the highest in the world, especially in the telecommunications, finance, retailing and insurance industries (Economic Analytical Unit, 2002; Simon et al., 2002). Rapid information and communication technology take up has allowed producers to reduce the prices of their services, benefiting consumers and often increasing export competitiveness (Simon et al., 2002).

Exports Respond

As a result of Australia's widespread reforms, many firms adjusted well to open markets and reforms. Manufacturing exports have grown 9 per cent per year since 1990, 2 per cent faster than overall merchandise exports.

AUSTRALIANS ENJOY THE BENEFITS

As producers upgraded their management and labour practices and adopted new technologies, Australian consumers, workers and businesses benefited. Higher productivity growth improved living standards at a faster rate than ever before. Lower tariffs gave Australians access to many new, better quality goods and services and prices for many consumer goods fell, increasing community purchasing power, choice and living standards.

⁸ One index of intra-industry trade rose from 66 in 1984-5 to 80 in 1996-7 (Productivity Commission, 1999a).

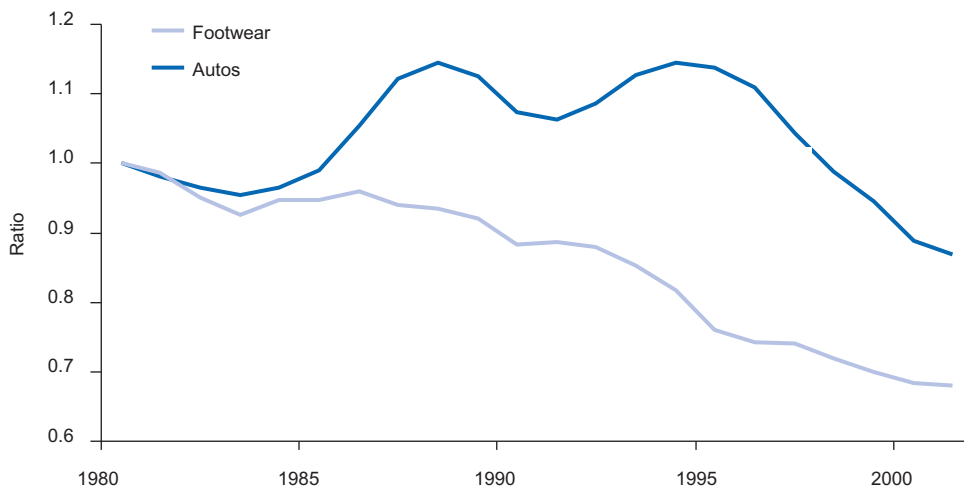
New Products, Cheaper

As tariffs came down, Australians could purchase most consumer goods, including major items like cars, more cheaply (Figure 4.7) (Henry, 2002). Also, household incomes rose sharply, further increasing the affordability of many traded goods.

Figure 4.7

Products Cheaper Due to Free Trade

Price of Footwear and Autos Relative to All Other Prices, 1980=1, 1980-2001



Source: CEIC, 2002.

REFORM DRIVES PRICES LOWER

Throughout the 1990s, increased competition, including through trade liberalisation, forced firms to pass cost savings on to consumers via lower prices and to keep their profits at modest levels (Parham et al., 2000). Sectors of the economy experiencing faster rates of productivity growth lowered their prices more rapidly ensuring consumers benefited from firms' investments in new production processes. Throughout the 1990s and 2000s, reflecting in part these competitive pressures, inflation has been significantly lower than in the 1980s and 1970s.

Living Standards Rising Faster

As a result of all these reforms, including a more internationalised Australian economy, in the 1990s Australia's real per capita GDP grew on average 2.1 per cent per year, faster than in any other post war decade except the 1960s (Australian Treasury, 2002b; Parham, et al., 2000). In 2001-02, Australians were around 55 per cent better off than in 1979-80, with real GDP per capita of around A\$36 000 compared with around A\$23 000, in 2001-02 dollars. Australia was one of only eight out of 26 Organisation for Economic Cooperation and Development, OECD economies to grow faster in the 1990s than in the 1980s.

DISTRIBUTING THE GAINS

Enabling all social groups to share in the gains from reform and globalisation is an important aspect of Australia's globalisation success. Sustained investments in education, training and the social safety net as well as flexible labour markets have improved social mobility, allowing people to respond to opportunities and competitive pressures and maintaining equity. Targeted retraining programs also have assisted this process. As a result, despite the major adjustments in the Australian economy and rapid rise in living standards over the past two decades, Australia's income distribution has remained relatively unchanged.

Investing in Education

Investing in education and training is vital to ensure people can move into industries in which Australia is competitive, thereby capturing the gains of globalisation. (See Chapter 2 – *Domestic Policies Matter*.) Especially in the 1990s, technological change significantly increased Australia's demand for skilled workers (OECD, 2001).

Australia's education system seeks to equip its workforce to access the opportunities globalisation offers. Australia benefits from a high rate of tertiary education participation, building on secondary completion rates of close to 75 per cent (OECD, 2001). Australia spends more on tertiary education than most other developed countries, at around 1.6 per cent of GDP compared with an OECD average of 1.3 per cent in 2001.⁹ Australia's expenditure per full time equivalent student also was above the OECD average for all sectors except preschool. The private sector provides more funds to education than in many other developed countries: in 2001, around 24.5 per cent compared to the OECD average of 13.4 per cent (OECD, 2001).

⁹ The percentage of Australians with graduate and postgraduate qualifications almost doubled between 1991 and 2001 with 472 970 people, or 3.2 per cent of the population, holding a postgraduate degree, graduate diploma or graduate certificate (*The Australian*, www.theaustralian.com.au, 4 September 2002).

Australia's health system seeks to provide all residents with sustainable access to essential health care services through a blend of public and private funding arrangements. Australia spends roughly the same share of national income on health as the OECD average, but has better than average health outcomes (OECD, 2001).

Assisting with Structural Change

The Australian Government also offers structural adjustment packages to help communities and industries cope with structural economic change. Packages usually comprise retraining and education, industry exit packages and programs to generate alternative jobs.

In 1998, as tariffs declined, the textiles, clothing and footwear assistance package allocated A\$770 million to encourage the industry to undertake strategic investments, develop markets, adopt new technology and adjust to international competition. In 2000, the sugar industry assistance package committed A\$84 million to cane growers to help with a weak sugar production cycle and low world sugar prices which largely reflects subsidies and trade barriers in world sugar markets. The package includes income support and interest rate subsidies (Department of Foreign Affairs and Trade, 2002).

In 2001, regions suffering high long term unemployment received assistance under the Wide Bay Burnett structural adjustment program, which committed A\$4 million to help new or expanding businesses and to local councils promoting employment prospects (Department of Foreign Affairs and Trade, 2002).

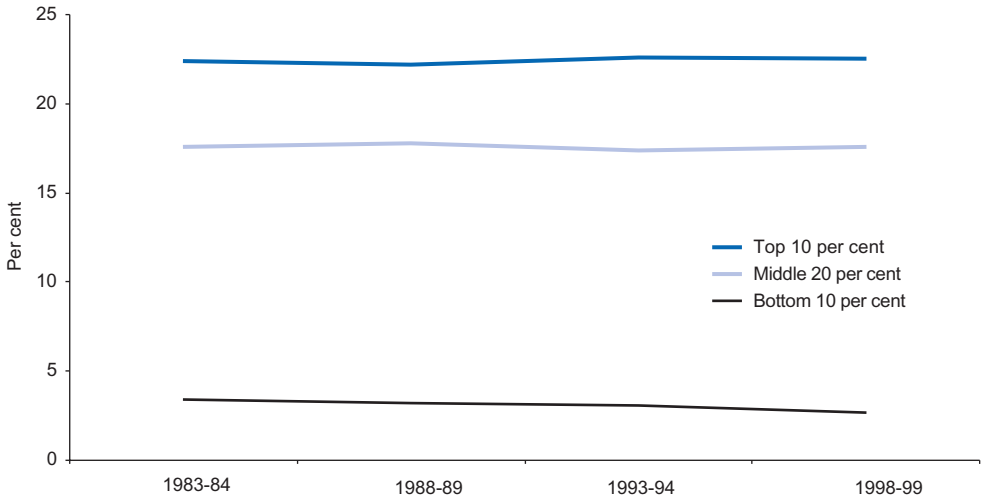
Since the second half of the 1990s, the Australian Government has strengthened the safety net for unemployed people, transforming it from a system solely providing benefit payments to one offering assistance and incentives for unemployed people to find new employment (Productivity Commission, 2002). Australia's 'Job Network' is the first in the world to use market mechanisms to provide subsidised employment matching services.

Inequality Trends Steady

Since the 1980s, Australia's income inequality has remained largely unchanged (Figure 4.8) (Parham et al., 2000). Taking taxes and government benefits into account, the living standards of Australia's low income earners have increased substantially since the early 1980s (Harding et al., 2002; Johnson et al., 1995).¹⁰

¹⁰ Whilst there arguably appears to be a slight downward drift in the share of the poorest 10 per cent in Figure 4.8, this is far less than opponents of economic reform suggest. Moreover, in absolute terms, the income of the bottom 10 per cent has increased by 50 per cent over the period covered by the graph. In any case, reflecting data limitations, the Australian Bureau of Statistics cautions against relying too heavily on data for the bottom decile when making living standards comparisons (Australian Bureau of Statistics, 2002b).

Figure 4.8

Inequality Steady**Income Shares of Household Disposable Income, Selected Percentiles, 1983-84 to 1998-99, Per cent**

Source: Harding et al., 2002.

Workers' income share stable

Workers also have maintained a stable share of national income. By the late 1990s, the share of wages and salaries in total national income was around 55 per cent, similar to the levels of the late 1980s and the early 1970s (Parham et al., 2000). Reforms and investment in education ensured Australian workers' productivity grew strongly over this period, enabling them to take home higher real wages without generating inflation or pricing themselves out of employment.

IMPLICATIONS

Australia is a globalisation success story. Australia has been well served by its institutions which are transparent and accountable, helping it maximise the gains from globalisation. Australia's experience shows economies can reap substantial rewards from reducing tariffs and investment barriers if they undertake appropriate labour, capital and other market and regulatory reforms and invest in education and training, helping workers and industries adjust flexibly to new challenges and opportunities.

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APPENDIX 4.1

AUSTRALIA'S MARKET AND INSTITUTIONAL REFORMS

Goods and Services Market Reforms

In the 1980s and 1990s, Australian governments undertook a range of reforms to make goods markets more competitive and to help local firms compete better in global markets. For example, Australia overhauled its competition legislation establishing an independent regulator, the Australian Competition and Consumer Commission, to implement this legislation.¹¹ In the 1990s, the commission actively pursued firms abusing market power (Australian Competition and Consumer Commission, 2000). In industries with natural monopoly aspects, like core telecommunications, electricity and gas pipeline infrastructure networks, Australian legislation now guarantees firms access to these networks, promoting competition in service provision (East Asia Analytical Unit, 1998).

Federal and state governments also privatised or corporatised many state owned utilities. This lowered the cost of their services for business and consumers and, in banking, insurance and air transport, removed unfair competition with private enterprises. Governments also opened to private sector competition several sectors previously reserved for state enterprises, including electricity, railways, water, telecommunications and public works. In 1993, the Hilmer Report encouraged governments to agree to introduce competition to areas state owned firms dominated and review legislation restricting competition. One study estimates these reforms contributed up to 2.4 per cent to 1998 real GDP levels (Productivity Commission, 1999a).

Financial Market Reforms

From the early 1980s, successive governments also liberalised domestic financial markets. A small group of domestic banks had dominated Australia's financial services industry, protected by regulations prohibiting foreign banks from entering the Australian market to compete with them. In the early 1980s, authorities embarked on a range of reforms, increasing banks' operational flexibility, competition and funding levels (Edey et al., 1996).¹² Banks' efficiency improved as they cut margins, generated new financial products and boosted technological uptake, including automatic teller machines and electronic banking (Davis, 1996). By the mid 1990s, the financial sector had nearly doubled its size from the early 1980s (Edey et al., 1996).¹³

¹¹ The Trade Practices Act, 1974 prohibits mergers or acquisitions which result in a substantial lessening of competition, monopolies from misusing their market power and outlaws firms preventing or deterring market entry. It also prohibits horizontal and vertical arrangements between firms which result in a substantial lessening of competition and prohibits individual firms with substantial market power from taking advantage of that power.

¹² Reforms allowed banks to decide whether to lend to firms at interest rates they chose. Large government deficits in the 1970s and early 1980s coupled with high inflation increased demand for market determined interest rates so financial institutions could price risk better.

¹³ Difficulties in the banking sector in the late 1980s and early 1990s greatly increased Australian banks' focus on risk measurement and management. For example, Australian banks maintain credit bureaus, separating credit management from credit origination and manage credit risk at the group level. More recently, banks have established independent risk management groups to assess all risks bank groups face.

These financial sector reforms helped create the environment for Australians to access and use foreign capital efficiently and minimise the impact on Australia of the 1997 Asian financial crisis. Reforms also improved firms' access to new capital, helping them grow and adapt to globalisation's competitive pressure.

Labour Market Reforms

As Australia opened its trade and investment regime and deregulated domestic markets, its regulated labour markets increasingly hindered firms from responding to rapidly changing conditions (Hilmer, 1989). Regulations kept wages in some declining sectors artificially high and maintained archaic wage relativities between different skill categories and industries.

Hence, in the late 1980s, the Australian Government began dismantling the centralised wage bargaining system. By the late 1990s, workers and employers could negotiate enterprise based Australian Workplace Agreements, as well as firm or industry based wage and salary agreements.

Building and Strengthening Institutions

Following two decades of institutional and regulatory reform, Australia's key economic and regulatory institutions and legislation are of a relatively high standard; this also increases firms' and citizens' ability to benefit from globalisation.¹⁴ Recent macroeconomic policy innovations include introducing in 1996 the *Statement on the Conduct of Monetary Policy*, providing the Reserve Bank with operational independence from the Federal Government. The *Charter of Budget Honesty*, introduced in 1998, increased the public transparency of fiscal policy. Macroeconomic policy now focuses on medium term outcomes, with monetary policy aiming to achieve 2-3 per cent inflation on average over the course of an economic cycle. Business tax initiatives and indirect tax reforms undertaken by the Government in recent years has given Australia a modern and internationally competitive taxation system.

¹⁴ Australia ranks highly on measures of institutional quality, ranking equal twelfth out of 159 countries in government effectiveness, eleventh out of 168 countries in regulatory quality, twelfth out of 169 countries in rule of law, and thirteenth out of 160 countries on control of corruption (Kaufmann et al., 2002).

GLOBALISATION DRIVES EAST ASIA'S SUCCESS

KEY POINTS

- More than any other developing region, East Asia demonstrates the power of globalisation to drive growth and reduce poverty.
- Opening to world markets and investment flows and pursuing export oriented growth were central to East Asia's rapid development in the 1980s and 1990s.
- Governments of successful East Asian economies also ensured local markets functioned efficiently and invested in infrastructure and education to help businesses and communities maximise the gains from globalisation.
- Hence, over the past three decades, East Asian growth reduced poverty more rapidly than ever before in human history.
- However, particularly since the 1997 Asian financial crisis, regional governments realise they must further upgrade regulation of financial markets, corporate governance and institutional quality to encourage investment and sustain future growth.

EAST ASIAN GLOBALISATION TRENDS

East Asia has embraced globalisation as its core development strategy. From the 1950s to the 1990s, most East Asian economies lowered tariffs and pursued export oriented growth strategies. However, opening to trade and investment was only part of East Asia's successful economic model. High savings and investment rates, solid investment in education and infrastructure, sound macroeconomic policies, generally flexible domestic labour markets and reasonably efficient regulatory institutions allowed successful East Asian economies to participate effectively in the global market place and grow rapidly (World Bank, 1993). Excluding Japan, the region's average per capita income grew from under US\$400 in 1985 to over US\$4 000 in 1997 in current prices. By contrast, more inward looking South Asian economies' average per capita income increased only from around US\$270 in 1985 to US\$400 in 1997 (Kokko et al., 2001).

Trade

From the 1950s, Hong Kong and Singapore operated free trade ports and in subsequent decades Taiwan, the Republic of Korea, ROK, Malaysia, China, Thailand, Indonesia and the Philippines adopted export oriented growth as the central element of their development strategies. As a result, the share of newly industrialising economy, NIE, and Association of South East Asian Nations, ASEAN, exports in world exports increased from 13 per cent in 1990 to 18 per cent in 1998 (Kokko et al., 2001). Other Asian economies, including most in South Asia, were slower to reduce their trade barriers and undertake essential reforms to labour markets and infrastructure sectors; their exports and output also expanded more slowly.

To encourage exporters, most East Asian governments adopted open trade policies, reducing tariffs significantly; in most regional economies average tariffs now are below 10 per cent (Figure 5.1).

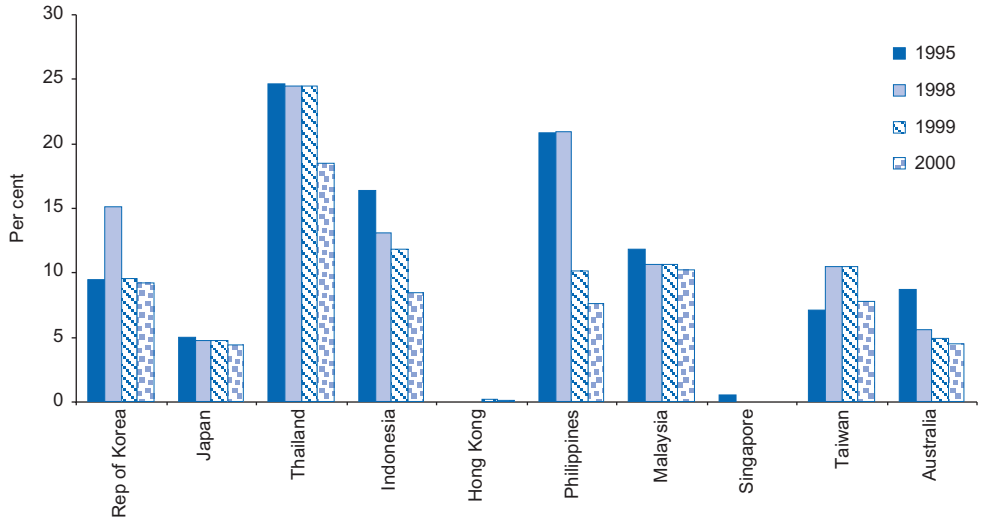
Labour Intensive Exports Important

From the 1970s, more open trade regimes combined with expanding urban and industrial labour supply due to a growing surplus in rural workforces, enabled a rapid expansion in labour intensive manufacturing and exports (Figure 5.2).

Figure 5.1

Average Tariffs Falling

Average Nominal Applied Tariff Rates, Selected Economies, 1995-2000, Per cent

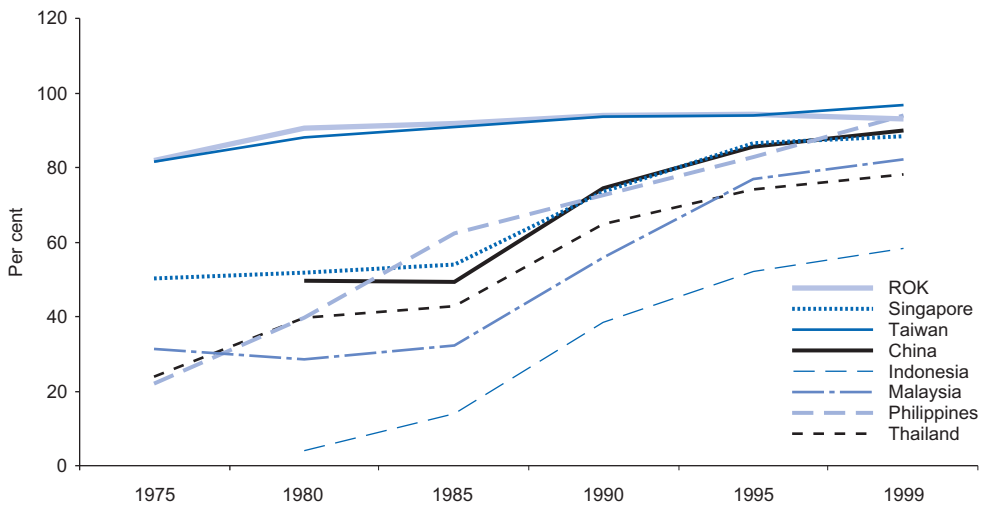


Source: Australia-Japan Research Centre, 2001.

Figure 5.2

Manufacturing Exports Growth Strong

Manufacturing Exports as Share of Total Exports, Selected East Asian Economies, 1975-99, Per cent



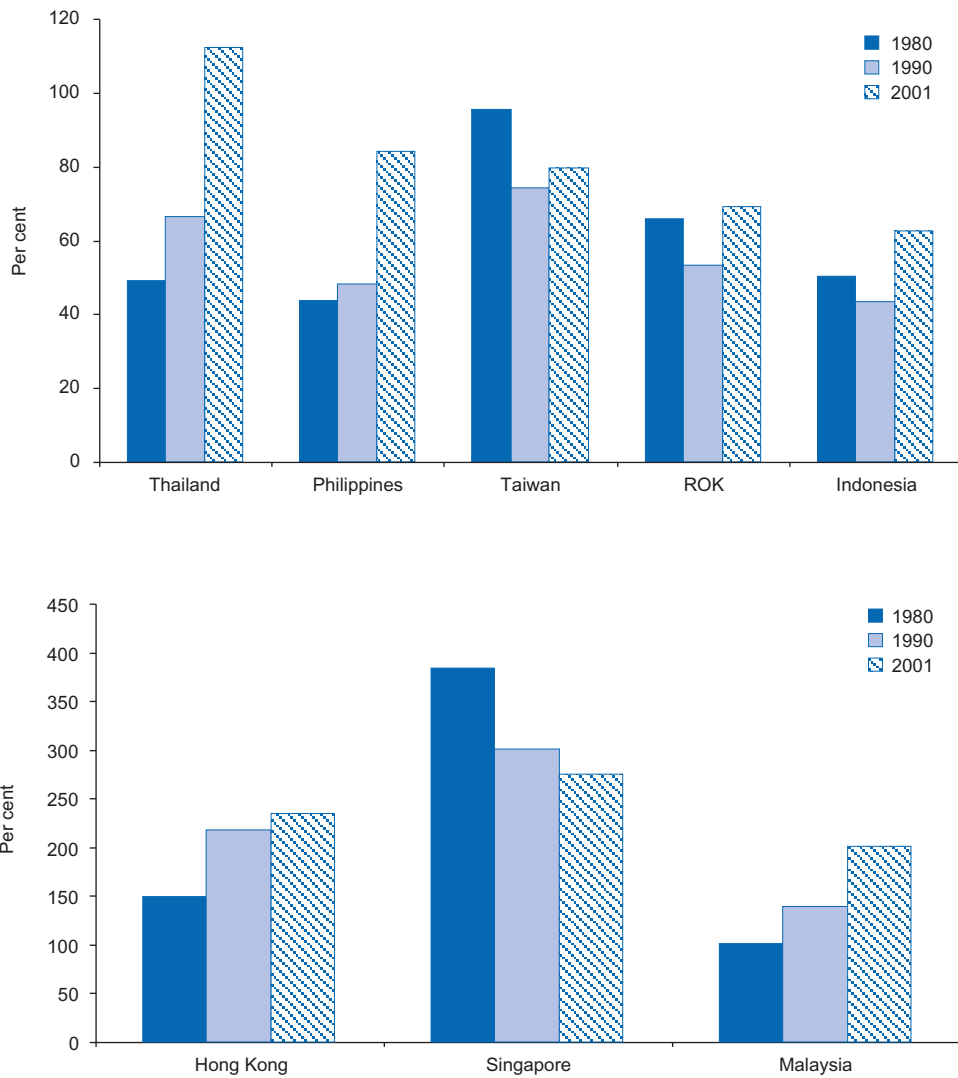
Source: Asian Development Bank, 2002

Hence, open trade regimes and other domestic reforms meant East Asian economies had high or sharply rising ratios of trade to gross national income, indicating the region’s growing integration with the global economy (Figure 5.3).¹

Figure 5.3

Trade Exposure High

Share of Total Trade in GNP in East Asia, Selected Years, Per cent



Source: Asian Development Bank, 2002

¹ As it developed, Singapore’s role as an *entrepot* has declined relative to its production of higher value added components and provision of services, resulting in a declining ratio of trade to GDP. Nevertheless, it remains a highly open economy.

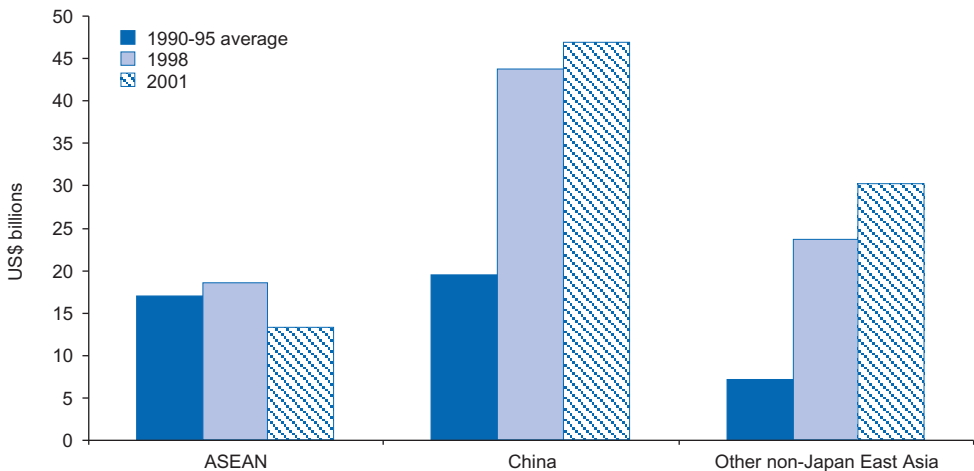
Foreign Investment

As the NIEs and ASEAN economies lowered their investment barriers their foreign direct investment, FDI, inflows also increased markedly, increasing overall investment and integrating them more closely with the global economy. Between 1990 and 2000, FDI flows to the NIEs, ASEAN, China and other non-Japan East Asia increased six fold (Figure 5.4). However, by 2000 these flows increasingly favoured China; its inward FDI is up nearly 30 fold since 1990 and it now accounts for a majority of non-Japan East Asia's inflows (Asian Development Bank, 2002). By contrast, FDI flows to ASEAN excluding Singapore have declined since the Asian financial crisis; its 2000 FDI flows were 35 per cent lower than 1990 levels and 76 per cent lower than in 1996 (Asian Development Bank, 2002).

Figure 5.4

East Asia's FDI High

FDI Inflows, Selected East Asian Economies, Selected Years, US\$ billions



Source: Asian Development Bank, 2002

BUSINESS FRIENDLY ENVIRONMENTS

While East Asia's rapid growth was in large part export driven, sound domestic policies also were essential to its success. Without high savings and investment rates, flexible domestic markets for labour and goods, stable macroeconomic policies and supportive investments in education and infrastructure, East Asia would not have grown as rapidly in the 1980s and 1990s. These policies were vital to enabling East Asian investors and exporters to capitalise on the region's open global trade and investment regimes.

Looking ahead, middle income and developed East Asia will need to rely more on productivity improvements and innovation to drive growth. This will increase the need to strengthen economic institutions and capital markets, invest in human capital, attract FDI and support adoption of new technologies (World Bank, 2002b; Economic Analytical Unit, 2002b).

Governance

The World Bank estimates better economic policies and governance account for around 40 per cent of East Asia's superior growth performance compared with Sub Saharan Africa (World Bank, 1997). East Asian economies generally feature better quality regulations and enforcement than most other developing regions. Middle to high income regional economies, including Japan, Singapore, Hong Kong, ROK, Taiwan and Malaysia mostly feature relatively high quality regulatory standards and institutions (Economic Analytical Unit, 2002a). Hence most markets work well and governments provide essential public goods like infrastructure and education. However, prior to the 1997 Asian financial crisis, financial market regulation and efficiency was a notable area of weakness (East Asia Analytical Unit, 1999).

High Savings and Investment

East Asia's rapid growth relied heavily on its populations' high saving rates, well in excess of most developed country levels (Figure 5.5). High savings and the business friendly environment spurred rapid increases in investment, which accounts for a large share of NIE growth since 1960 (Young, 1995; Krugman, 1994). In the three decades to the mid 1990s, this also was true of Indonesia, the Philippines and Thailand (Bosworth et al., 1996). In the 1970s and 1980s, when exchange rates and other costs were competitive, regional banks channelled high savings to export oriented industry, absorbing excess labour from the agricultural sector and driving growth (Radelet et al., 1997). However, by the early to mid 1990s, as local exchange rates appreciated and export industries became less competitive, much new bank lending flowed to real estate, retailing and other service sectors, which often became over supplied.

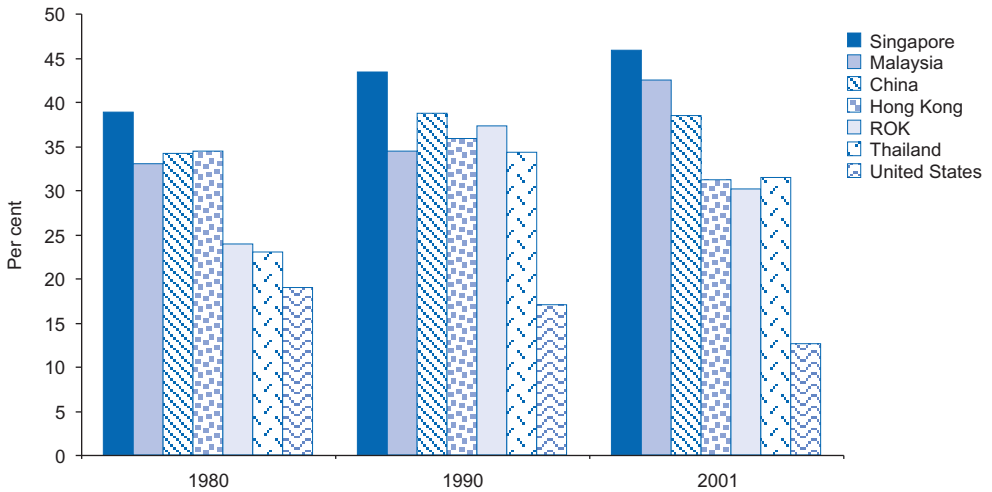
Investing in Education and Health

Importantly, many East Asian governments also invested heavily in education, adding significantly to their populations' human capital and workforce quality. High literacy levels increased workers' ability to adopt new technologies (Figure 5.6). One study found East Asia's per capita education spending has been higher and its impact on growth greater than in other developing regions (Radelet et al., 1997). For example, another study found Malaysia's strong educational investment raised work force productivity by about 1 per cent per year from the 1970s to early 1990s (Bhalla et al., 1992). High education investment also helped workforces access the new technologies that FDI and trade introduced, containing inequality (Asian Development Bank, 1999). Several studies indicate knowledge diffusion is the main benefit of FDI for developing East Asia; high investments in education amplify such gains (Asian Development Bank, 1999).

Figure 5.5

East Asian Savings High

Savings as a Share of GDP, Selected Economies, Selected Years, Per cent

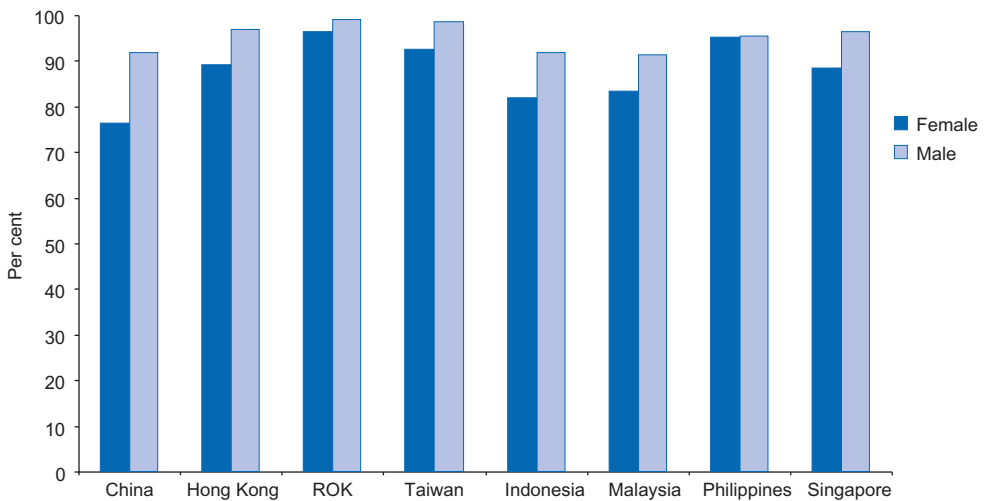


Source: Asian Development Bank, 2002

Figure 5.6

East Asia's Education Strong

Male and Female Literacy Rates, Selected East Asian Economies, 2000, Per cent



Source: Asian Development Bank, 2002.

Rapid Technology Uptake

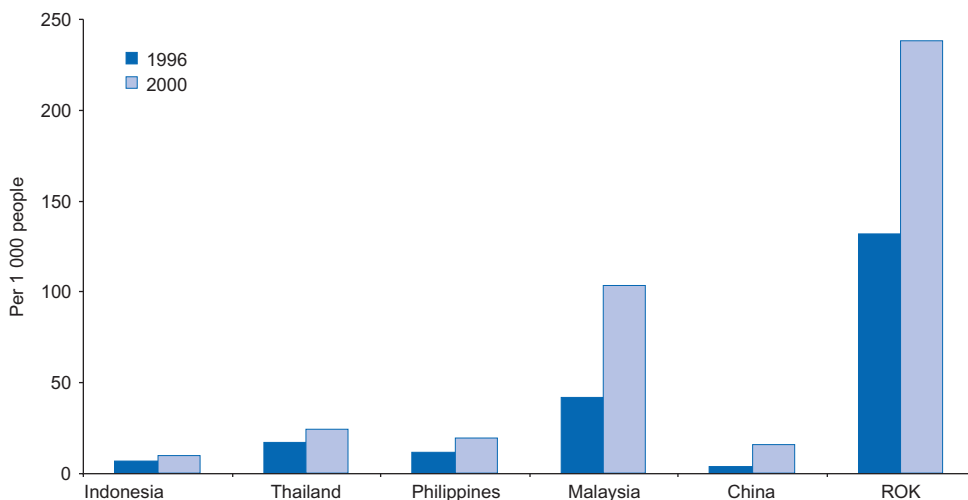
According to the Asian Development Bank, successful East Asian economies also employed a range of effective policies and institutions to accelerate their rate of new technology uptake, spurring productivity and living standards growth (Asian Development Bank, 2001). To maximise technology transfer, governments funded research institutions and assisted export industries to adapt cost saving foreign technologies (Asian Development Bank, 2001).² Many successful East Asian economies invested heavily in technical training and education; Hong Kong, Singapore and Taiwan have larger shares of post secondary students enrolled in scientific and engineering studies than most other comparable economies. Finally, focussing on export competitiveness gave local firms strong incentives to keep pace with the latest technological developments (Asian Development Bank, 2001).

As a result of these policies, East Asia rapidly increased its uptake of new technology including recently information and communication technology, ICT (Figure 5.7). East Asia's ICT market is large and growing rapidly; in 2001, the region spent US\$613 billion on ICT goods and services, 24 per cent of world ICT spending, up 9 per cent annually since 1993 after adjusting for inflation (Economic Analytical Unit, 2002b).

Figure 5.7

Technological Uptake Rising Fast

Personal Computers Per 1 000 Persons, Selected East Asian Economies, 1996 and 2000



Source: World Bank, 2002a

² For example, the Republic of Korea and Taiwan established publicly funded advanced research institutes staffed by Western trained scientists and engineers and encouraged them to link to the commercial sector.

Sound Macroeconomic Policy

Regional governments' macroeconomic policies also support their economies' successful globalisation. Before the 1997 Asian financial crisis, most East Asian governments ran conservative fiscal policies, with small budget deficits or surpluses. This kept inflation low, maintaining their exports' cost competitiveness. However, in the lead up to the crisis, de facto pegged exchange rates undermined export competitiveness and tight monetary policy to counter the inflationary effects of capital inflows pushed up local interest rates, encouraging foreign borrowing to rise sharply. This became a trigger for the crisis.

Since the crisis, virtually all regional governments have freed their exchange rates, making monetary policy easier to implement. Unfortunately, many governments have incurred significant public debt bailing out failed banks and guaranteeing depositors' savings. Nevertheless, several economies like the ROK and Malaysia are embarking on long term fiscal repair programs to wind back public debt.

Good Infrastructure

Government provision of sufficient reasonable quality transport, electricity and telecommunications infrastructure is a major contributor to East Asia's economic success. This allowed local producers to expand their production and maintain international competitiveness. Private sector investment accounts for around 10 per cent of today's infrastructure investment in East Asia.

IMPACT ON EAST ASIA

Until the mid 1990s, generally sound domestic policies worked in tandem with relatively open trade and investment regimes to drive rapid per capita income growth in the NIEs, China and ASEAN (Figure 5.8). Between 1987 and 1998, China's real GDP grew at an average rate of 8 per cent and the NIEs and ASEAN grew at over 6 per cent (Asian Development Bank, 2001).

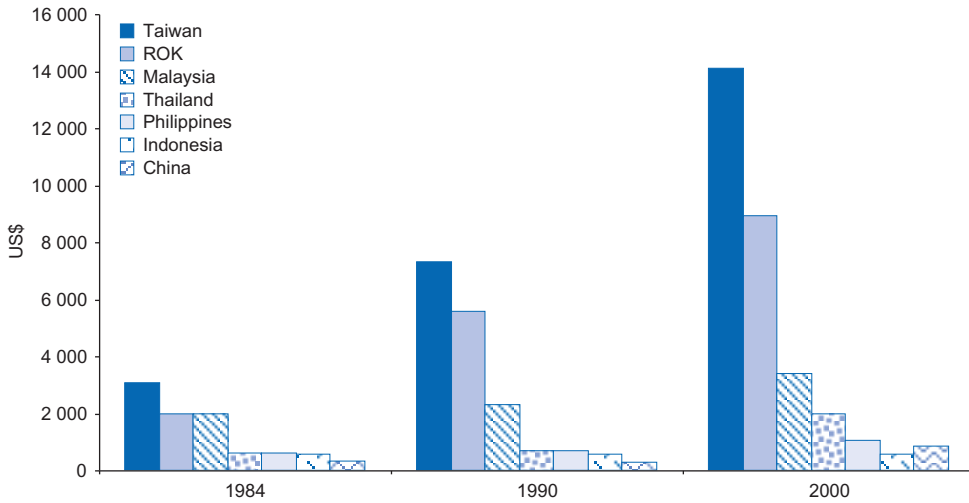
East Asia's export oriented policies created hundreds of millions of more productive, better paid jobs for low skill workers making major inroads into poverty (Figure 5.9). Between 1987 and 1995, the share of East Asian populations living on less than US\$1 per day fell from 34 per cent to 9.6 per cent. Indonesia made the most dramatic progress, reducing the share of its population living on less than US\$1 per day from over 60 per cent in 1975 to around 11 per cent by 1995.³ Similarly, the share of China's population living in poverty fell from about 60 per cent in 1980 to 22 per cent in 1995 and only 15 per cent in 2000 (Kokko et al., 2001).

³ Although this share increased somewhat after the crisis, it is still 16 per cent (World Bank, 2002a).

Figure 5.8

East Asian Living Standards Rising Rapidly

Per capita GNP, Selected East Asian Economies, US dollars, 1984, 1990 and 2000

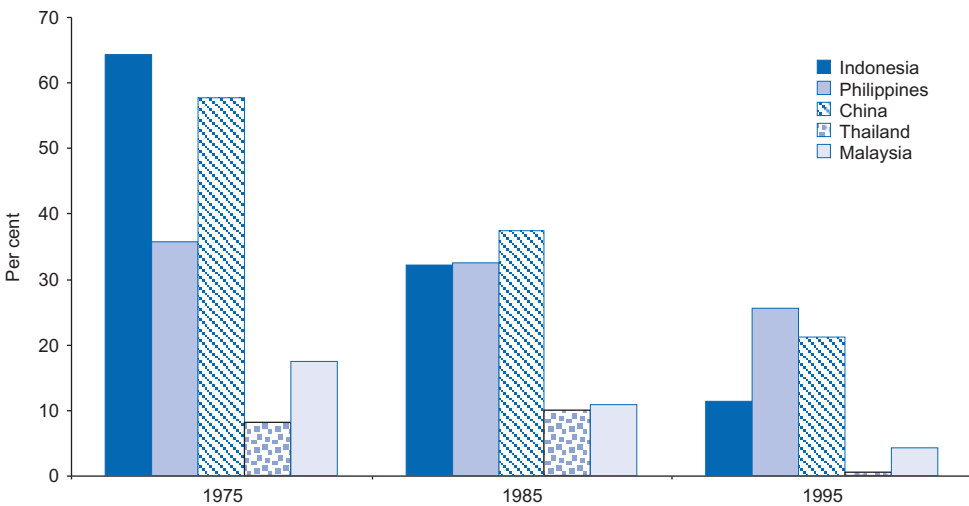


Source: Asian Development Bank, 2002

Figure 5.9

Poverty Falling Rapidly

Share of the Population Living in Poverty, Selected East Asian Economies, Selected Years, Per cent



Source: Kokko et al., 2001.

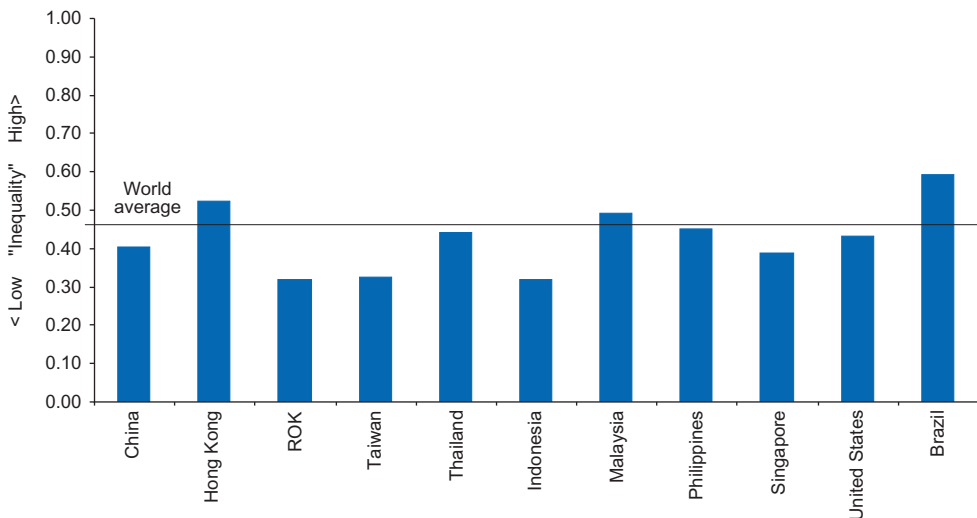
GROWTH WITH EQUITY

Importantly, rapid growth in low skilled employment opportunities and appropriate poverty reduction policies helped most East Asian economies avoid increasing inequality and several actually reduced it. Hence, by the late 1990s, East Asian economies' inequality generally remained well below global averages (Figure 5.10). Apart from open economies, strong investment in education and rural development ensured this favourable outcome.

Figure 5.10

Equity Well Above World Averages

Gini Coefficients, Selected Economies, Various Years



Notes: The Gini coefficient measures the degree of inequality in the distribution of income in a given economy. A Gini coefficient of zero indicates each member of a community receives exactly the same income while a Gini coefficient of one indicates the top 10 per cent of the economy receives all the income and the rest nothing. Data are for 1993 in Singapore, 1996 in Hong Kong, 1998 in China, 1999 in Indonesia and Taiwan and 2000 in ROK, Thailand, the Philippines, United States and Brazil.

Source: Asian Development Bank, 2002; Stanford University, 2003.

Basic Education Spending Targeted

East Asian economies' education policies generally supported improving equity as economies grew. To increase equity and maximise returns from education spending, most East Asian economies spent relatively more of their education budget on basic education. This improved people's access to new technologies, particularly agricultural technologies in rural areas and prevented a major divide emerging between an educated elite and uneducated mass (Asian Development Bank, 2001). For example, the ROK allocates around 10 per cent of its education budget to higher education whereas Venezuela, which has a more unequal income distribution, allocates around 40 per cent to this sector (World Bank, 1993).

Overcoming the ‘poverty trap’, which makes it costly for households to send a child who could be working to school, is important for improving education access for poor people. Since the crisis, Indonesia’s ‘Stay in School’ program, which provides grants to the poorest schools and transfers to the poorest students to prevent them leaving school, is showing early signs of success (Birdsall, 1997). Bangladesh’s ‘Food for Education’ program, which offers a stipend to selected students, produces nearly full school attendance amongst participants (Asian Development Bank, 2001).

Rural Development

The divide between urban and rural areas usually accounts for most inequality within developing economies. (See Chapter 2 – *Enabling Globalisation*.) Successful East Asian economies like Malaysia invested heavily in ensuring rural areas shared in development and could access the gains from globalisation.⁴ While the Philippines attempted land reform, it has been less successful in promoting rural development; its income inequality remains relatively high by East Asian standards (Figure 5.10) (East Asia Analytical Unit, 1998).⁵

Fairer Asset Distribution

Compared with Africa and Latin America, East Asia enjoys a more even distribution of productive assets, especially land, promoting a more equal distribution of income (Figure 2.A2). While this partially reflects historical conditions, land reform and titling programs in China, Vietnam, the ROK and Japan also promoted more equal access to land.

FUTURE PRIORITIES

While much of East Asia successfully is capturing gains from trade and investment opening, many developing regional economies could gain more from globalisation and particularly international capital flows. The sudden withdrawal of foreign capital during the 1997 Asian financial crisis and failure of several developing East Asian economies to attract FDI since then have alerted governments of the need to improve their economic and legal governance and business environments.

Improving Savings Allocation

The 1997 Asian financial crisis revealed weaknesses in many East Asian financial systems. Government owned or influenced financial institutions often channelled savings to sectors governments targeted. For example, Korean financial institutions provided huge volumes of credit

⁴ In Malaysia, for example, policies included consolidating and rehabilitating poor land holdings to improve farm productivity, investing in rural infrastructure to improve market access, subsidising technological inputs to raise farm productivity, assisting smallholder and traditional farmers to diversify and multi-crop, supplementing rural incomes through promoting small scale labour intensive industry and ensuring rural areas received adequate road, electricity, education and health spending (Zin, 2000).

⁵ The Philippines also reduced trade barriers and adopted export oriented development policies very late and has maintained relatively high minimum wages, inhibiting labour intensive manufacturing.

to *chaebol* which initially drove the ROK's industrialisation and globalisation but increasingly invested in low return projects in over supplied sectors (Economic Analytical Unit, 2002a). Although such government policies sometimes accelerated technological uptake, reducing credit costs to these firms undermined discipline on them to invest wisely and also squeezed out other potential investors, typically small and medium enterprises.

Furthermore, prior to the crisis, credit often was allocated along relationship lines to well connected entrepreneurs rather than to the most commercially sound investments (Economic Analytical Unit, 2002a). This was particularly true of government owned banks and private banks within conglomerate groups. East Asian banks also often on-lent funds they borrowed abroad, frequently in domestic currency to unhedged borrowers. When local currencies collapsed and real estate bubbles burst, these banks' balance sheets became highly exposed and many banks collapsed.

Responding to these concerns, since the financial crisis, most regional governments have introduced tougher new prudential regulations and strengthened enforcement institutions to increase corporate and bank transparency, reduce risks of bank collapses and improve credit allocation quality. Eventually, new securities markets laws also should help establish safer financial markets to compete with the banking sector for savers' funds and in providing credit.

Strengthening Economic Institutions

While developed East Asian economies like Singapore, Hong Kong, Japan, the ROK and Taiwan and even middle income economies like Malaysia generally have sound government institutions and reasonable corporate governance, developing East Asian economies' economic institutions and regulations would benefit from significant strengthening (Figure 5.11) (Economic Analytical Unit, 2002a; East Asia Analytical Unit, 1999).

Improving Productivity

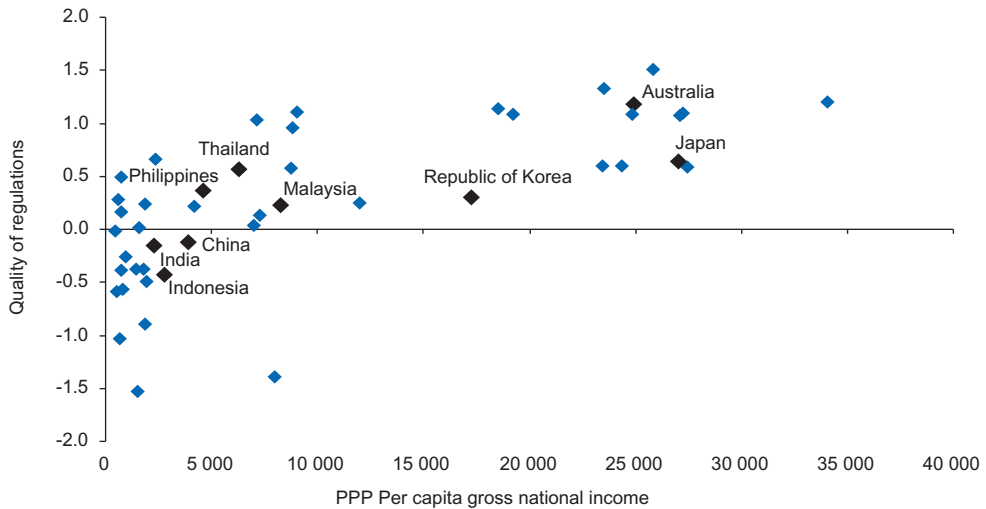
Before the financial crisis, some analysts identified East Asia's declining capital productivity as a problem, as the region's growth relied mainly on massive accumulations of capital and new entrants to the workforce (Krugman, 1997; Young, 1995). Low levels of competition often encouraged investment in unproductive areas, contributing to low capital productivity; in several East Asian economies, restrictions on new entrants competing with government monopolies and FDI, and the presence of large local companies undermines competition. This has also resulted in high profit margins for local producers and high prices for consumers.

Many regional governments now are drafting or implementing new competition laws preventing dominant market players deterring smaller market entrants from operating. Most also have liberalised FDI regimes in recent years. Privatising state owned enterprises, breaking up state and private monopolies or abolishing controlled prices also are important for improving productivity and allowing economies to gain from globalisation.

Figure 5.11

Developing East Asia's Regulations Still Weak

Quality of Regulations and Gross National Income, \$US, Selected Economies



Notes: Based on a survey of 46 countries this measure included the quality of public service provision and bureaucracy, civil service competence and credibility of government policy. See Kaufmann et al., 2002 for more details. The purchasing power parity, PPP, approach to calculating real GDP values the total bundle of goods and services a population consumes each year at the price they would cost in the United States. Hence PPP per capita income adjusts ordinary US dollar measures of per capita income to take account of the fact that goods and services that are not traded internationally often are sold in developing, and even other developed, economies more cheaply than in the United States, increasing consumers' real purchasing power.

Source: Kaufmann et al., 2002.

Innovation

As China's emergence as a labour intensive exporter challenges many economies, most are seeking to differentiate their exports and move up the value chain into products that use innovation and human capital more intensively (Economic Analytical Unit, 2003 forthcoming; World Bank, 2002b). Improved intellectual property rights and better functioning capital markets especially for venture capital can help stimulate technological innovation (APEC, 2001). Japan, the ROK and Malaysia are fostering clusters of ICT activity in an effort to accelerate innovation (World Bank, 2002b). For developing regional economies like Indonesia, Thailand and the Philippines, investing more in technical education is essential to improve the workforce's ability to take advantage of new technologies.

Opening Services Sectors

According to the World Bank, government policies restricting FDI in and imports of consulting, legal, accounting, marketing and other professional services also constrain productivity growth by inhibiting financial and other markets' performance (World Bank, 2002b). For example, one study found productivity levels in Japanese and Korean construction, retailing and health sectors are 40 to 60 per cent lower than in the United States (McKinsey Global Institute, 2000). Opening these markets to foreign and domestic competition and removing outdated regulations would help bridge this productivity gap and stimulate growth (World Bank, 2002b).

Social Safety Net

Although most East Asian governments invest in human capital to spread the gains of globalisation, the region generally does not feature well developed social safety nets. In the late 1990s, their absence undermined regional economies' ability to address quickly the social consequences of the financial crisis (Asian Development Bank, 2001). For example, following the 1997 financial crisis, the ROK's social programs rose from very low levels to close to 5 per cent of the government budget, but by 1998 still only 7 per cent of the 1.5 million unemployed received any benefits (Asian Development Bank, 2001). Similarly, following the crisis, Indonesia's social spending, mainly on public works and rice distribution schemes, rose to 3.6 per cent of the budget, but only around one third of needy households benefited (Asian Development Bank, 2001).

ASIA'S NON-GLOBALISERS

A small number of East Asian economies, most notably the Democratic People's Republic of Korea, DPRK, (North Korea) and Burma, have chosen not to integrate with the world economy. These economies' populations have suffered a significant deterioration in their living standards, highlighting the crucial link between trade, development and poverty reduction.

DPRK

The DPRK's guiding ideology of *juche*, or self-reliance, which eschews contact with the global economy and employs central planning rather than markets to allocate resources have produced mass poverty and starvation for its population (US Library of Congress, 2002).⁶ At the end of the Korean War, the DPRK and the ROK (South Korea) had similarly low incomes but most of Korea's mineral wealth and industrial capacity was located in the north. In 2001, as a result of 50 years of negligible trade and central planning, the DPRK's per capita income was only about 5 per cent of the ROK's US\$9 000 per capita income and its foreign trade flows were less than 1 per cent of the ROK's. Analysts believe about 2.5 million North Koreans died of starvation in the late 1990s (AP News, 2001).⁷

Burma

At the end of WWII, the World Bank identified Burma, with its abundant natural resources and (then) relatively high levels of human capital, as one of the economies most likely to grow rapidly in East Asia. However, since the 1960s, Burma's military leaders have pursued the 'Burmese Way to Socialism', cutting the economy off from international trade and adopting self-sufficiency and state ownership. By the early 1970s, the closed, state run economy was performing poorly, with economic growth negative or negligible.⁸ By 1997, Burma's estimated GDP per capita had sunk as low as US\$1 14, or \$971 in PPP terms, compared to neighbouring Thailand's per capita income of US\$1 970, or \$6 550 in PPP terms (East Asia Analytical Unit, 1997; World Bank, 2003).

⁶ Self reliance also operates at the local level, with provinces and even counties expected to fill their own consumer goods and social services needs, with the state removing any surplus grain for the cities (*Asia Times*, www.atimes.com, 21 February 2001).

⁷ Official estimates were 230 000 victims.

⁸ International sanctions against the Burmese Government and relatively high trade and investment barriers isolated the economy from the global marketplace.

IMPLICATIONS

Successful East Asian economies provide some of the world's best examples of how powerfully globalisation can drive growth and reduce poverty. High ratios of exports to GDP and large FDI inflows characterise virtually all successful East Asian economies. These economies also demonstrate that for communities to benefit from globalisation, governments need to provide reasonable quality mass education, infrastructure and economic and legal institutions and to show a commitment to social equity.

In the 2000s, central challenges facing the region include rebuilding weakened banking systems and ensuring regional economies can attract and benefit from international capital and technology. Most regional governments are responding to these challenges and extending the gains from globalisation by strengthening their economic and commercial policies and regulatory institutions.

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IMPLICATIONS

KEY POINTS

- The experience of Australia and East Asian economies shows adopting open trade and investment regimes and pursuing export oriented growth can raise economic growth rates and reduce poverty.
- However, to achieve robust and well distributed growth governments also must upgrade continually their governance and institutions to ensure markets function effectively and deliver efficient social and physical infrastructure services.
- Australian and East Asian economies' experiences also show unilateral trade and investment reform generates a large share of the benefits from open markets; waiting for other economies to lower barriers first is neither necessary nor desirable.
- To help developing economies prosper in world markets, developed economies must continue opening their markets to developing economy imports, especially in agricultural and labour intensive manufacturing products, and assist developing economies strengthen governance.
- Opportunities for development assistance include continuing to develop institutions which promote open trade and investment regimes, reinforcing governance in key economic, social and legal institutions and assisting with education and infrastructure provision strategies.

This report's conclusions have several significant policy implications for governments seeking to maximise potential benefits for their populations from a more globalised world. These include the need to strengthen continually economic governance and regulations to ensure markets function efficiently in a rapidly changing global market environment. Investing in education and training and other social and physical infrastructure also are important to help economies remain competitive and spread more evenly opportunities to access the benefits of globalisation.

POLICY IMPLICATIONS FOR EAST ASIAN GOVERNMENTS

Most East Asian governments have used global markets effectively to advance their communities' economic development. Nevertheless, to resume pre crisis growth levels, most East Asian governments recognise they need to strengthen domestic institutions and improve the efficiency of local markets.

Strengthening Economic Governance

A strong correlation exists between institutional strength, sound governance and per capita GDP growth. Hence, by undertaking long term investments in developing institutions, governments can help promote their economies' growth and reduce poverty. Economies with secure property and contractual rights may achieve developed economy income levels at twice the rate of other economies. By contrast, poor domestic governance and low transparency that allows elite groups to capture the benefits of regulations or lobby for rents significantly reduces returns on investment and contains growth.

Many developing East Asian economies still fail to define and protect basic property rights, undermining economic security and discouraging investment. Overcoming this constraint on growth requires improved legislation and more efficient and predictable court systems to secure property rights, including titling in rural areas and urban slums, enforcing contracts and protecting intellectual property.

Financial Market and Corporate Governance Reforms

Lack of confidence in some East Asian economies' banking sectors, share markets and corporate sectors has limited the growth of new investment in these economies, reducing their growth rates below potential long term levels. As markets provide the best discipline on financial institutions and corporates, opening domestic economies more fully to foreign direct investment, FDI, enhancing domestic competition policies and requiring increased disclosure of company balance sheets are important methods of improving corporate and financial institution performance. Most regional governments have embarked on the task of strengthening their prudential and corporate governance regulations and enforcement; however, in the area of enforcement, much remains to be done. In particular, legal provisions protecting minority shareholders, directors' responsibilities and the courts' enforcement of creditors' rights remain inadequate in most developing regional economies. The

dominance of majority family owned corporates among listed firms in many regional economies also undermines managements' commitment to pursuing minority shareholders' interests. (See detailed recommendations in East Asia Analytical Unit, 1999 and Economic Analytical Unit, 2002.)

Labour Market Reform

Many East Asian economies possess flexible labour markets, which facilitate rapid employment growth in competitive sectors and allow labour shedding from declining sectors. This has allowed wide sections of the population to leave agriculture and other low productivity activities to find jobs in higher productivity industry and service sectors, accelerating economic growth, raising income levels and improving equity outcomes. However, in a few East Asian economies, more rigid labour market practices and minimum wage levels set above market clearing wages prevent local firms from becoming internationally competitive, reducing potential employment and income gains from open economies. These governments could benefit from reviewing their labour market regulations and institutions to identify impediments preventing labour moving smoothly into potential growth sectors. Developing training and job search programs, especially in rural and depressed regions, also could help improve labour mobility and reduce unemployment in most regional economies.

Other Market Reforms

As firms relying on state granted monopolies, regulated prices or subsidies generally are inefficient, high cost producers which find it difficult to compete in world markets, regional governments would benefit from identifying and removing these market distortions. Priority areas for reform include corporatising and privatising state owned enterprises and introducing and enforcing competition policies to ensure new entrants can challenge dominant local players. Other priorities include removing, or at least more effectively targeting, subsidies for infrastructure services, consumer goods and productive inputs. Such subsidies send distorted price signals to consumers and producers, creating waste, shortages or unsaleable surpluses.

Trade and Investment Reforms

While all regional governments have reduced trade barriers in the last decade, several ASEAN economies and the Republic of Korea still have relatively high trade barriers in particular sectors. Most ASEAN economies also limit foreign investor access to many sectors. Australian and East Asian trade reform experience shows the benefits of open economies and international competition in increasing the productivity and competitiveness of local manufacturers, farmers and service providers. Such trade reform does not need to be reciprocal to be beneficial. Export oriented firms exposed to international competition adopt new technologies faster, pay higher wages and are more likely to expand production and employment than are protected firms. Reducing barriers to international trade and investment, unilaterally and through bilateral, regional and multilateral trade negotiations should remain a high priority for many regional governments.

When considering trade reform, governments need to focus on broad community welfare gains rather than narrow sectoral interests. However, some regional governments and a number of developed economies outside the region, focus instead on the costs agricultural trade reform could impose on local farmers. This position often is based on an underestimation of farmers' capacity to respond to competition and capitalise on world market demand, particularly if governments provide adequate rural infrastructure and extension services and allow rural credit institutions to develop. Those resisting agricultural trade reform often underestimate the significant benefits lower food prices provide developing economies' urban poor, who can spend up to 80 per cent of household budgets on food. Lower agricultural product prices also increase the competitiveness of a wide range of domestic industries which use agricultural inputs.

Trade reforms often act as a catalyst for financial sector, labour market, utilities and taxation reforms, further accelerating productivity, income and employment growth. This is because producers competing in international and open domestic markets typically demand governments undertake such reforms so they can remain competitive.

Taxation Reform

Reforming taxation laws and strengthening taxation authorities are important to overcoming growing national debt burdens so governments can maintain stable macroeconomic environments for producers and consumers. Increased taxation effort also is essential to finance public goods, including infrastructure, basic education and health care.

Education Policy

East Asian governments typically spend more on education and have achieved better educational outcomes than most other developing region governments. However, several developing East Asian economies could improve the quality and equity of distribution of education services and strengthen education service delivery institutions. In particular, several regional economies would benefit from ensuring more efficient and equitable delivery of education services in rural areas and to low income groups in urban areas. In this context, recent initiatives to reduce school fees and increase the years of compulsory schooling in some regional economies are a welcome development.

Technological Uptake

East Asia rapidly is increasing its uptake of information and communication technologies, ICTs, but in the case of developing regional economies, this is from a low base. To increase the pace of ICT uptake, boost productivity levels and so spur growth, several regional governments usefully could expand investment in mass technical education and promote more robust market competition, including in capital markets. Opening services sectors to greater foreign participation also could assist in introducing ICT to these economies.

Adjustment Policies Sometimes Needed

While opening an economy to international trade and investment raises overall community welfare, during the adjustment phase some community members can lose out. By their nature, reform benefits usually are spread widely across many consumers and producers while their costs can fall on producers and workers in a few industries that previously were protected from competition. Developed economies like Australia have found unemployment support linked to training of affected workers is the most effective method of addressing this issue. To date, few East Asian economies except Japan have implemented targeted compensation programs to assist restructuring associated with economic and trade reform. However, short term, often crisis-related relief efforts also can be targeted better if they address retraining of affected groups rather than merely income support.

TRADE POLICY IMPLICATIONS FOR DEVELOPED ECONOMIES

Freer access for developing economy exports to developed economy markets contribute significantly to developing economies' gains from globalisation.

Trade Access Essential

Developed economy agricultural policies and trade barriers on labour intensive manufactures prevent many developing economies producing more output in sectors where they are most efficient, blocking key development avenues. Developed economy trade reforms also benefit their consumers and producers and boost overall productivity and growth rates. However, to continue pursuing trade reforms, developed economy governments need to confront domestic lobbyists in agriculture and labour intensive manufacturing and consider reallocating funds currently subsidising inefficient producers to helping them move into production lines or sectors of the economy in which they can be internationally competitive. Through the Cairns Group, Australia continues to urge reforms to developed economy agricultural policies that damage developing and developed economy agricultural exporters.

The Doha Agenda

The WTO Doha Round should be crucial to removing developed economy trade barriers and agricultural subsidies and addressing a range of other trade issues concerning developing economies. A successful Doha Round would deliver substantial gains to developing and developed economies.

OPPORTUNITIES FOR DEVELOPMENT ASSISTANCE

While governments play the dominant role in determining their economies' development path and outcomes, well targeted aid can play a catalytic role in assisting developing economies open their economies to international trade and investment and strengthen governance so they can benefit more from globalisation. Aid interventions must be considered and designed in the context of

individual economy circumstances, taking account of partner governments' priorities, poverty reduction strategies, relative capacities and stage of development. Within this context, the report's findings identify several areas where continuing donor focus could further assist regional economies maximise the benefits from globalisation.

Australia's aid program already is active in helping developing regional economies meet the challenges and opportunities of globalisation, particularly through its strong focus on public sector, corporate governance and trade reform. This assistance includes programs to strengthen the rule of law, improve economic and financial management, promote public sector reform, advance trade reform and develop trade negotiation capacity. International financial institutions, particularly the World Bank, Asian Development Bank and International Monetary Fund, also play a leading role in helping governments in the region strengthen economic governance.

Aid to Promote Growth

In highlighting crucial areas for regional government action, the report also prioritises areas for donor assistance. In several low income ASEAN economies and to some extent China distortions in capital, labour and product markets and weak property rights prevent communities deriving maximum benefits from international trade and investment, providing important opportunities for donors to assist.

Australia has experience and technical expertise relevant to strengthening economic and corporate governance. Australia's aid program already supports a range of partnerships between key Australian economic and legal institutions and their developing East Asian counterparts. In future, these links usefully could be extended to cover institutions in a wider range of regional developing economies in key areas like macroeconomic management, taxation, trade reform and negotiation, prudential control, commercial law development and enforcement and infrastructure, education and health planning. Following models Australia has developed in China and elsewhere such assistance could link longer term training for middle level professionals to technical assistance, shorter courses and policy dialogues between senior management to develop an effective long term strategy for building institutional capacity. In the high priority area of trade reform, Australia already assists developing regional governments participate more effectively in the major trade negotiations by training trade officials and strengthening local capacity to research the gains from trade and other economic reforms.

To help markets work more efficiently, priority areas for assistance include helping authorities corporatise and privatise state owned enterprises and introduce and enforce competition policies, advise on removing or more effectively targeting subsidies for infrastructure services and productive inputs and in selling nationalised bank and corporate assets. To improve security of property rights, titling projects usefully could be extended in future. As well, assistance with developing laws and court systems to enforce contracts and protect physical and intellectual property can contribute significantly to promoting investment and growth.

Helping to strengthen regional economies' macroeconomic policy institutions to secure low inflation and reduce debt levels to more sustainable levels has been an aspect of Australia's development assistance over recent years; this usefully could be extended. Assistance to help reform taxation laws and strengthen taxation authorities also is essential to overcome growing national debt burdens and provide public goods including basic infrastructure, education and health services. Priority areas include assistance to governments to improve tax design, legislation and administration to help achieve a more efficient and equitable mix of income and expenditure taxes and to strengthen taxation collection agencies.

Australia's Virtual Colombo Plan aims to help developing regional economies bridge the digital divide between people with and without access to new information and communication technologies. To increase the pace of technology uptake, other priorities include assisting governments to invest in broad based technical and information technology education and training, improve intellectual property rights protection and develop better functioning capital markets, especially for venture capital.

AUSTRALIA'S EXPERIENCE

Australia has considerable experience in economic, corporate and legal governance reforms, efficient and open goods, financial and other services markets and a highly developed education sector. Its institutions can assist counterparts in the region across priority areas.

Adjusting to Globalisation

Australia has experience in labour, capital and product market reforms and developing social safety nets. Organisations like the Productivity Commission have the experience to assist developing regional governments measure the gains from economic reform policies and develop adjustment strategies.

Economic Governance

Australia's stable investment environment owes much to its public and private institutions, including its central bank, prudential supervisor, securities regulator and the private financial services industry, including the stock exchange. Australia is generally aligned with internationally accepted accounting and auditing standards. With donor support, Australia's economic policy makers and regulators, professional associations and NGO sector already help develop counterpart organisations in South East Asia and China, including economic ministries, central banks and associations of auditors, accountants, shareholders and directors; such assistance usefully could continue to help sustain these linkages.

Education and Technological Uptake

Australia already is active in the area of education and has expertise suitable to help strengthen the capacity of educational ministries and institutions in the region. Australia also has experience in decentralising education provision to ensure efficient and equitable delivery in rural and regional areas, a priority in several developing regional economies.

SUMMING UP

The successful globalisation experiences of Australia and many East Asian economies show how opening economies to international trade and investment can boost growth and reduce poverty. However, government must combine such trade and investment opening with effective economic, governance and structural reforms to achieve stable and well distributed growth in living standards. To reduce poverty, aid donors should continue to support activities driving economic growth including freeing international trade and investment and strengthening governance and social and infrastructure service delivery by key economic, social and legal institutions. To ensure developing economies can prosper in global markets, the current Doha Round needs to improve market access for agricultural products and labour intensive manufactures. Through its aid policies and strong support for multilateral trade reform Australia is helping developing economies gain more from globalisation, while Australia's own economic reforms ensure Australians are major beneficiaries of the open international trading system.

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