

## CHAPTER 2

# Operating environment

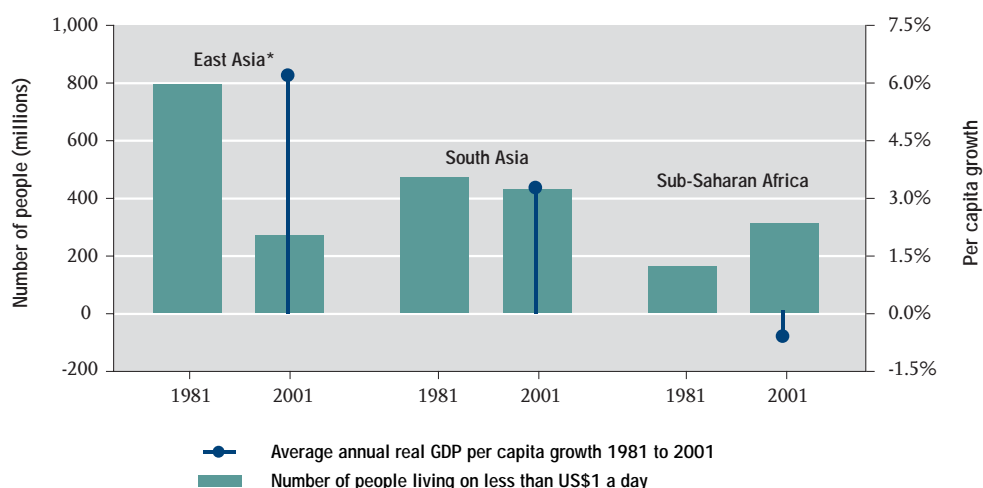


## 2 Operating environment

### 2.1 Development performance and prospects

Asia has seen remarkable economic growth and, as a result, rapid reductions in poverty. Some 520 million people were lifted above living on US\$1 per day in East Asia over the twenty years to 2001. The percentage of people living on less than US\$1 per day in East Asia dropped from 58 per cent in 1981 to 15 per cent in 2001 and from 52 per cent to 31 per cent in South Asia over the same period. This trend is continuing, fuelled by the rapid growth of China and India, and through capitalising upon greater opportunities for economic integration.

**FIGURE 1 Poverty and growth in Asia and Africa**

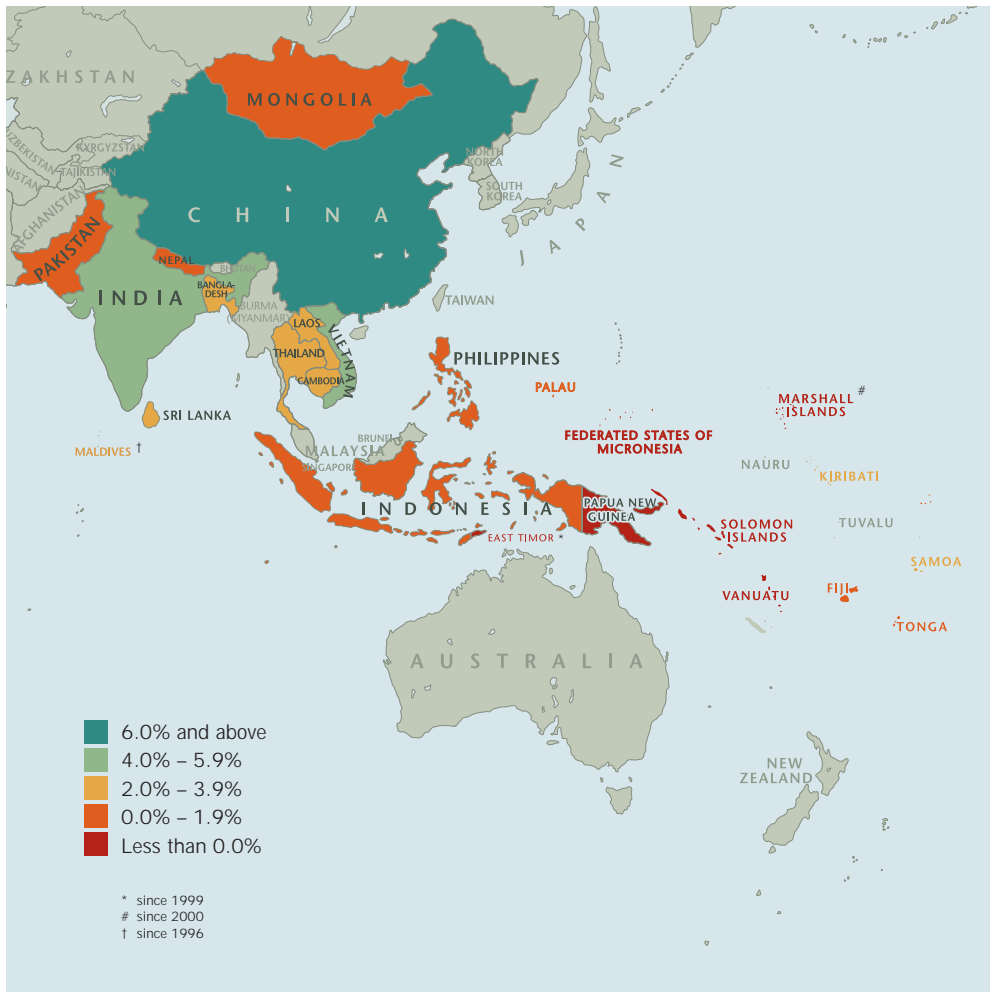


Source: Chen and Ravallion (2004) and World Bank Development Statistics Online.

\* The average GDP per capita growth figure shown for East Asia is the average for East Asia and the Pacific. Growth figures are based on GDP at constant 2000 US\$.

Despite this impressive performance, the Asia-Pacific region remains a poor part of the world. While Africa continues to be the most poorly performing region, including in its progress towards the MDGs, in Asia some 700 million people still live on less than US\$1 a day and 1.9 billion live on less than US\$2 a day, including over half the population of Indonesia. Asia is making progress towards meeting the human development MDGs, but much of the Pacific is not, and even in Asia there are no grounds for complacency. Many parts of the Asia-Pacific region, including PNG, much of the Pacific, East Timor, Indonesia and the Philippines, face serious challenges to achieving sustained growth and poverty reduction. Map 2 highlights the vastly varying economic growth rates of countries in the region over the past decade.

**MAP 2** Average annual GDP per capita growth  
in the Asia-Pacific region, 1995 to 2004



The disparities between the successful and the less successful parts of the region are expected to continue and possibly widen over the next ten years. The less well performing economies are likely to continue to struggle to take advantage of the opportunities afforded by greater global growth, particularly in China and India, and economic integration. Despite Indonesia's steady economic performance since the Asian financial crisis, and its even more impressive transition to democracy, the Indonesian Government faces serious challenges in generating the growth required to make significant inroads into poverty. Together with the Philippines, Indonesia also faces deteriorating competitiveness, due in no small part to deficiencies in physical infrastructure. PNG, East Timor and much of the Pacific lack the policies and institutions, as well as the human capacity and physical infrastructure, to capitalise successfully on regional growth. These countries pose a particular development challenge. Australia remains ready to work with Burma and the Democratic Peoples' Republic of Korea, but those countries are still politically and economically disengaged.

## 2.2 Regional challenges

### Stability and security

Social stability is one of the most important preconditions for sustained growth and poverty reduction. The poorest 20 per cent of the world's people suffer from 80 per cent of the world's civil wars. Experiences in Bougainville and Solomon Islands have shown the devastating impact that conflict can have on hard-won development gains. The links between security and development have never been clearer and are well expressed in the Government's *Peace, Conflict and Development Policy* (2001).

Regional stability over the next ten years will depend in part on how the great power relationships evolve between the United States, Japan, China and India and on how the region accommodates the economic and political rise of China and India. Apart from ongoing tensions between nations in such areas as the Korean Peninsula, Kashmir and the Taiwan Strait, there are also continuing intrastate tensions, such as those in the southern Philippines and parts of Indonesia. The Melanesian islands of PNG, Vanuatu, Solomon Islands and Fiji continue to be prone to instability. In all these countries, broad-based growth will be critical to shore up support for democracy and to promote stability.

Wherever the fear of terrorism exists, it will deter investment and employment generation. For example, the Bali bombings are likely to have a lasting impact on the island's economy, disproportionately affecting the poor who depend on tourism for their livelihood. While poverty is not a primary cause of terrorism, challenging economic prospects provide fertile recruiting grounds and, coupled with weak governance, havens for terrorist networks to flourish.

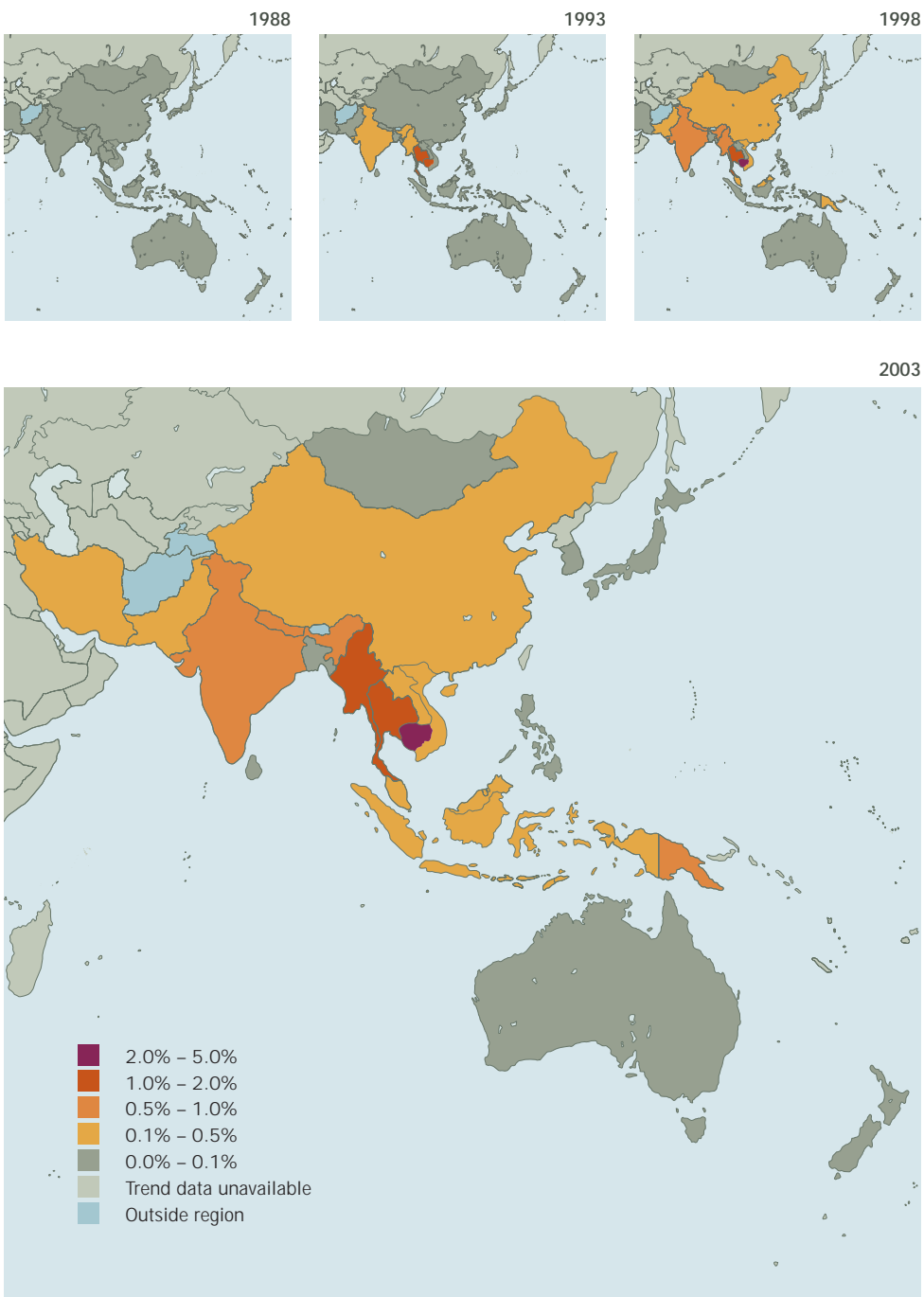
### Transboundary issues

Transboundary threats to the Asia-Pacific region's development and stability are growing. Because of its dense and rapidly growing populations, the region is among those most vulnerable to infectious disease and environmental degradation.

An estimated 8.3 million people are living with HIV/AIDS in Asia and the pandemic is spreading rapidly. The Pacific is also affected, with PNG presenting a particularly disturbing scenario. In the absence of vigorous and effective prevention responses, it is predicted that the Asia-Pacific region will account for 40 per cent of all new infections by 2010 — another 12 million people — threatening to make the region the new epicentre of the pandemic. Map 3 shows the prevalence of HIV/AIDS as a percentage of the adult population, and its rapid spread from 1988 to 2003.

Pandemics have immediate and dramatic impacts. The 1918 influenza pandemic killed one to two per cent of the world's population and many experts think the world is on the cusp of the next big pandemic. If one does break out, there is a strong chance it will do so in Asia. Estimates of the cost of the severe acute respiratory syndrome (SARS) outbreak range from \$13 billion to \$40 billion. Already, 70 per cent of emerging infectious diseases are zoonoses (diseases that can be transmitted from animals to humans). Continuing population growth, degradation of the natural environment and the intensification of animal production systems all increase the likelihood of zoonotic disease outbreaks. These factors also place a premium on preparedness and response capacities and the maintenance of animal health.

MAP 3 HIV/AIDS in the Asia-Pacific region — adult prevalence, 1988 to 2003



With rapid growth in Asia, environmental concerns are intensifying, not least through tensions over environmental degradation and access to natural resources. Competition for resources, including energy, is likely to grow. Water is often cited as a potential source of regional tension, such as over the use of water from the Mekong River. Urbanisation and pollution from rapid industrialisation are affecting environmental health and air quality. This is leading to a greater incidence of respiratory infections, as is transboundary haze from poor forestry practices in Southeast Asia. As well as having direct negative impacts, these problems can undermine public health, which in turn reduces opportunities for growth and development. Increasing demands for energy and resulting climate change will also become more important for development planning in the coming decades.

Asia is particularly prone to severe natural disasters. The 2004 tsunami and earthquakes in the Indian Ocean killed more than 275,000 people and caused up to \$19 billion damage. The recent South Asia earthquake killed 74,000 people and left 2.5 million homeless. China and Bangladesh suffer from regular and increasingly severe flooding. The Pacific continues to suffer from devastating cyclones, and their frequency and intensity may increase due to global warming. Managing and responding to natural disasters should be central to any development planning scenario.

### Demographic challenges

More than half of the world's population lives in Asia and the Pacific. This proportion is set to increase to 63 per cent by 2050, by which time the region's share of the global population over 60 will more than double, from 9 per cent in 2000 to 23 per cent by 2050. The challenge of an ageing population is particularly acute in Japan, but will also emerge in the next half century in China, Sri Lanka, Thailand and, indeed, Australia.

In contrast, many of the less economically successful countries in Australia's region have the highest population growth rates and are experiencing 'youth bulges'. East Timor has had one of the highest fertility rates in the world, with an average of nearly eight children per woman. PNG, Solomon Islands, Vanuatu and the Philippines also have youth bulges, as do tiny microstates such as Tuvalu. This will place a premium on generating employment-creating growth to avoid worsening poverty levels and growing social tensions.

The drift of populations to urban centres will continue. By 2015, Asia will be home to 17 of the world's 27 mega-cities. If urban population growth is not matched by employment opportunities and new industries, social instability is likely to increase. This is a risk for the Pacific as well as Asia. In Melanesia, the combination of youth bulges, urbanisation and lack of employment opportunities is leading to rising crime, particularly among young men. This combination of factors is also a source of political instability as disaffected youth are rallied to support real or perceived grievances. Atoll countries such as Kiribati are facing particular problems of 'jobless urbanisation'.

## Integration

The Asia–Pacific region is becoming increasingly interconnected. In Asia, economic integration is well under way. About 50 per cent of Asian trade is now within Asia. Several bilateral and regional trade agreements have been forged or are under negotiation. The imperatives of these trade arrangements, as well as World Trade Organization (WTO) accession and membership, are shaping policy and institutional reform throughout Asia. Subregional connections are also growing. For example, strong trade flows with China are creating an economic growth corridor along the Mekong.

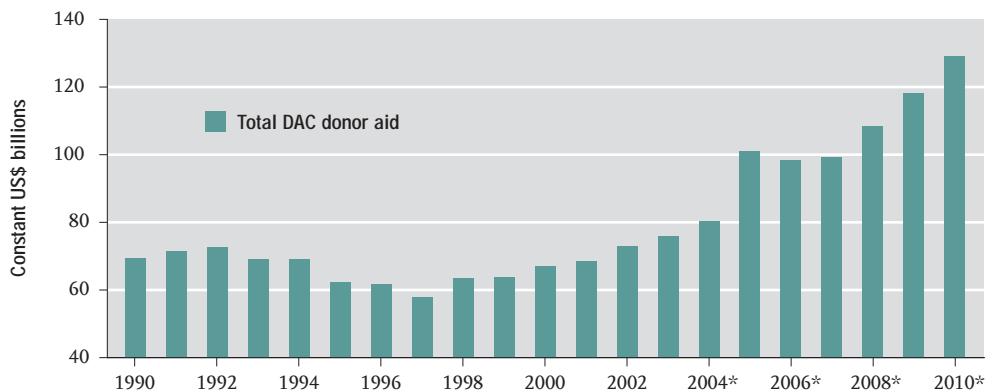
Political links are also increasing. China continues to look outwards and, apart from its growing political and economic influence, is emerging as a significant donor to the region (it is among the largest bilateral donors to the Pacific). India is looking to its east. The East Asia Summit has brought together the Association of Southeast Asian Nations (ASEAN) membership plus three (China, Japan and South Korea) with India, New Zealand and Australia. In the Pacific, initiatives such as the Pacific Plan are seeking to pool government resources and provide services on a regional basis.

## 2.3 International response to global poverty and development

There is now a heightened international awareness of the problems of global poverty and development. This springs from humanitarian concerns as well as a growing realisation that the problems of the developing world can quickly become the problems of the developed world. This awareness translated into the adoption of the MDGs at the UN Millennium Summit in 2000, setting out development goals for poverty alleviation, health, education and gender equality.

Most developed countries have announced significant increases in aid funding — global aid levels are expected to rise from US\$57 billion in 1997 to US\$130 billion by 2010. Development issues have been at the centre of major international meetings over the past several years, including the G8 Summit in 2005, leading to a number of major initiatives to tackle African poverty, debt and HIV/AIDS.

FIGURE 2 Global aid levels, 1990 to 2010



Source: DAC International Development Statistics (IDS) Online; OECD DAC Secretariat.  
 \* OECD DAC Secretariat projections.

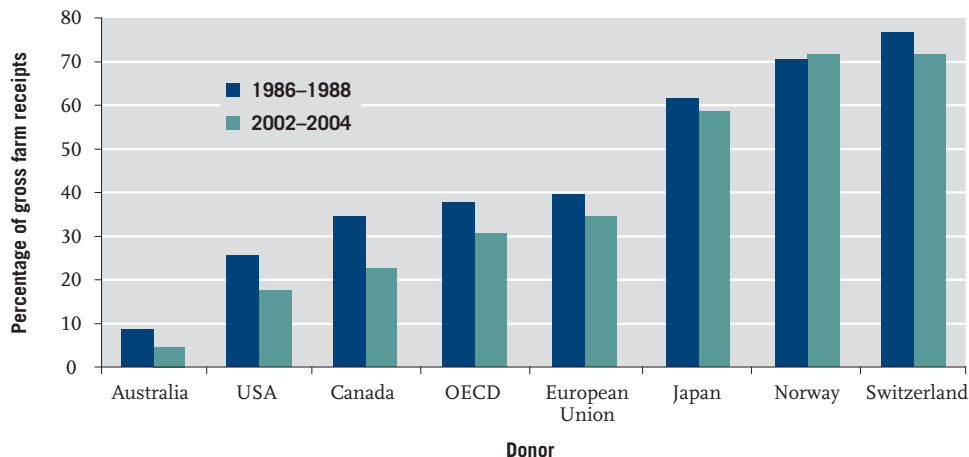
Figures are Official Development Assistance (ODA) and are in constant 2004 US\$.  
 ODA refers to official government overseas aid expenditure. The OECD Development Assistance Committee (DAC) comprises 22 of the world's major bilateral aid donors.

The latest WTO round of multilateral trade negotiations has been labelled the 'development round', but progress to date has been disappointing. While the Government welcomes the recent announcements of global aid increases by many bilateral donors, the effectiveness of such increases will be undermined by continuing high levels of agricultural and other protection by both developed and developing countries. Trade barriers also directly contribute to the debt problems of developing countries because they reduce the capacity of those countries to service debt. While estimates vary of the impact that greater trade liberalisation would have on future poverty reduction, one thing is certain — substantial liberalisation has the potential to lift many millions out of poverty. For example, the World Bank estimates that the complete liberalisation of merchandise trade would lift an additional 32 million people out of poverty by 2015.

Australia is among the world leaders in reducing trade barriers to developing countries, and has progressively reduced trade subsidies for agriculture. Figure 3 shows the 'producer subsidy equivalent' (estimated support to agricultural producers, expressed as a percentage of gross farm receipts) for six countries, the European Union, and the Organisation for Economic Cooperation and Development (OECD) as a whole. The OECD annually assesses its member countries, using this as the principal tool for monitoring and evaluating agricultural policies. Australia's producer subsidy equivalent stands at just 4 per cent, in contrast to Norway's and Switzerland's at 71 per cent.



**FIGURE 3** Comparison of agricultural subsidies by country



Source: Producer and Consumer Support Estimates, OECD Database 1986-2004  
<http://www.oecd.org/dataoecd/49/27/35078982.xls>

## 2.4 Lessons learnt on development and aid

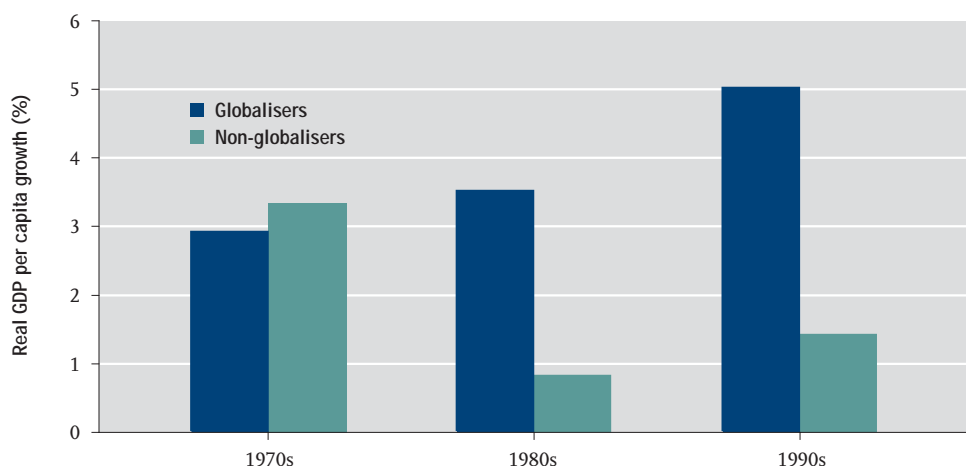
The heightened interest in and awareness of global development issues has also led to significant thinking about what makes countries successful and what makes aid more effective. Experience shows unequivocally that economic growth is the key to poverty reduction. This is illustrated by the contrasting experiences of sub-Saharan Africa and Asia, with the latter's consistently higher growth rates underlying its significantly more rapid poverty reduction (see Figure 1 at the beginning of this chapter).

It is also clear that countries that have integrated themselves into the global economy have grown more quickly than those that have not (Figure 5). In all countries that have sustained growth, the share of trade in gross domestic product has increased and trade barriers have been reduced. East Asia's economies, in particular, have been oriented outwards, and their impressive growth has occurred on the back of rapid trade integration.

This is not the whole story. Appropriate and effective institutions are essential drivers of long-term growth. Institutions that provide dependable property rights, manage conflict, establish macroeconomic stability, align economic incentives with social benefits and maintain law and order are an important foundation for long-term growth. There are various ways in which these general institutional pre-requisites for successful development can be met, but if they are not, growth will not be sustained.

This is best summed up in recent research by the World Bank. During the 1990s, many countries embarked on reform with the intention of fostering economic growth and reducing poverty. The results of those reforms were mixed: some achieved sustained growth with only modest reforms, while others failed to make gains despite extensive reforms. The analysis identified a clear link between sustained growth and macroeconomic stability, openness and a supportive business and investment climate, but it also highlighted the importance of tailored strategies that address a particular country's binding constraints as well as economic, social and political dynamics.

FIGURE 4 Growth records of globalising and non-globalising countries



'Globalisers' represent the top third of a group of 72 developing countries for which data was available, ranked by increases in their trade to GDP ratio between the mid-seventies and the mid-nineties. 'Non-globalisers' are the two-thirds with the least increase in their trade to GDP ratio.

Source: Dollar and Kraay (2004)

While growth is essential for poverty reduction, it is not necessarily sufficient. Some countries with rich resource endowments, such as Nigeria, Sierra Leone, PNG and Nauru, have experienced periods of high economic growth without notable improvements in living standards. Providing opportunities for people to participate in growth is critical. In some countries this has been done through land reform, in others by the wide provision of basic education and health services and by the pursuit of gender equity. The 2006 World Development Report emphasises the importance of equity for development, arguing that greater equality of opportunity for all citizens would not only provide poorer groups with more opportunities but would also accelerate aggregate growth.

Australia has also learnt important lessons on aid, both from its own experiences in Asia and the Pacific, and from other countries' experiences. Chief among these lessons are the following.

- Aid is only a small part of the growth and development picture. Developing country policies and institutions are more important. Other developed country policies are also critical, particularly trade policies.
- Well-targeted aid can be effective, but poor aid can do harm. It can undermine capacity, create dependency, absolve governments of their responsibility for the delivery of services and encourage rent seeking. Large inflows of aid can hurt exports by causing an appreciation of exchange rates (so-called 'Dutch disease').
- Building capacity for improved performance may take generations and expectations of aid must be realistic.
- For reform to be successful and sustained, it has to be driven by local champions.

- Approaches to improve governance must understand the local political context and, particularly in non-reform environments, support is best provided to help local people express their own demands for better services and performance.
- Alignment and integration of aid delivery with the developing country's own systems and policies is more likely to lead to sustainable results.
- Aid donors need to better coordinate and harmonise programs with each other to reduce fragmentation and transaction costs for developing countries.
- Greater emphasis needs to be placed on the evaluation and impact of aid programs, and the lessons should be fed into future policies, strategies and programs.

## 2.5 Fragile states

Many of the above lessons are also relevant to poorly performing or fragile states, but such countries require special and differentiated approaches — they tend to stay fragile for a long time, and experience suggests that they have little chance of improvement without outside intervention. Traditional aid approaches have often failed to deliver the expected outcomes because state policies and institutions are too weak to be able to mediate between competing interests and drive forward development-oriented programs of reform. Too often, the weak institutions of fragile states are unable to coordinate donors effectively. Therefore, the international community has sought to identify new, non-traditional ways to provide and coordinate aid in these environments.

The term 'fragile state' encompasses a wide variety of different circumstances, from post-conflict situations to protracted crises and stagnation, so assistance must be carefully calibrated to the individual country's circumstances and recognise the particular constraints of capacity and political will. Assistance needs to be flexible to take advantage of windows of opportunity and respond to changing conditions, but the low capacity of fragile states and the extent of challenges facing them mean that assistance is likely to be needed over decades. The long-term vision for international engagement must be on state building through support for increased capacity, legitimacy and accountability and for an enabling environment for economic growth. Further, the interdependence of the political, security, economic and social spheres requires policy coherence within the administration of each international actor.

Australia's engagement in fragile states in this region reflects these principles. Australia is taking a more systematic and longer term approach to state building that recognises that severe capacity constraints need a range of innovative responses. The Regional Assistance Mission to Solomon Islands (RAMSI) demonstrated the importance of a comprehensive approach to the law and justice sector — restoring law and order was fundamental, but policing interventions by themselves could not be sustained without functioning courts and corrective services. Community support for RAMSI has been strong — popular support is critical for successful reform and needs to be nurtured, including through support for initiatives with clear community benefits such as the restoration of health clinics or the reopening of schools.

## 2.6 Implications

Australia's aid program will need to take into account the continuously changing regional context in which it works and the lessons learnt about development and aid. The next chapter outlines the way Australia will position the aid program to deliver increased aid resources effectively.

