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Policy Insights No. 9

Adaptive Capacity and Inclusive Development

Results of the OECD Development Centre 2003-2004 Programme of Work

by Ulrich Hiemenz

Why is Capacity Building Crucial?

The Doha and Monterrey processes, as well as regional initiatives such as NEPAD, bear witness to the emerging global partnership between OECD and developing countries. The hallmarks of this partnership are a more intense co-operation based on national development strategies, an increased effort by OECD countries to facilitate the achievement of the Millennium Development Goals and greater involvement of developing countries in international rule-making. Progress has been made in all of these areas, indicating that the goal of all stakeholders is to make globalisation more inclusive – both among and within countries. However, the new responsibilities assumed by developing countries to spearhead their national development and to contribute to shaping the global economy are – especially in poor countries – not matched by adequate public and private capacities to meet them. The emerging global partnership between OECD and developing countries will thus have to focus on the twin objectives of supporting these countries in overcoming the challenges of globalisation while strengthening their adaptive capacity.

It is well understood that building capacity is a result of development itself. When economic growth helps to increase tax revenues and profits, the government and the private sector are able to strengthen institutions and invest in better infrastructure as well as productive capital. However, a certain level of public and private capacity is a precondition for making development happen. This latter aspect was the focus of the Development Centre Programme of Work in 2003-2004. The lessons learnt from the analyses carried out in the framework of this Programme are summarised in the subsequent pages. The Annex provides the written output on which this summary is based.

What Can OECD Countries Do?

In a globalising world economy, OECD and developing countries interact in a multi-layered way. There are macroeconomic linkages, resource flows in both directions (FDI and migration), trade linkages and development co-operation activities. In all these areas, OECD countries can, directly and indirectly, support developing countries in their efforts to participate in the international division of labour and to achieve a sustainable development path. The Centre has highlighted in particular four areas where OECD countries can make a difference: maintaining a stable macroeconomic environment with affordable interest rates; helping to mitigate risks; enhancing trade opportunities through improving the coherence of their own policies; and increasing financial flows for achieving the MDGs.

To Avoid Emerging Market Crises

Macroeconomic interdependence between the OECD and developing economies today is much less unidirectional than only a decade ago, mainly thanks to the catch-up which took place in Asia, in particular in China and India. The growth pattern of these countries could have a profound impact on global activity. At the same time the building of foreign exchange reserves by Asian countries in the aftermath of the Asian financial crisis could influence interest rate and exchange rate volatility. Nonetheless, business cycles in OECD countries as well as their exchange and interest rate policies are still important in determining international real interest rates and access to and volatility of international financial flows. In this respect high fiscal deficits in the United States coupled with an accommodating monetary policy could prove to be an explosive mixture for OECD and developing countries alike.

To Mitigate Risks of Natural Disasters

There is obviously little OECD countries could have done to prevent such natural disasters as the Tsunami tidal wave in South-East Asia, the earthquakes in Iran (and earlier Turkey) or hurricane Mitch in Central America. An analysis of these events shows, however, that an early adoption of pro-active measures could at least have saved many lives in the disaster stricken areas. Early warning systems, building codes and emergency planning can go a long way to mitigate the consequences of natural disasters in terms of human lives. OECD countries can play an important role in implementing such preventive measures by providing appropriate technologies and helping developing countries to finance the necessary investment. Likewise, there is a role for OECD countries not only in providing emergency relief but, more importantly, in supporting the reconstruction phase. Poorer people especially cannot save and do not have access to adequate insurance coverage, but are often disproportionately affected by natural disasters. Therefore OECD countries should not only allocate ODA to help these people during reconstruction; they should also engage in co-operative schemes involving the private sector and international financial markets to allow poor people to obtain affordable insurance coverage against shocks originating from natural disasters.

To Enhance Trade Opportunities

If developing countries are to catch up with advanced countries they will need to integrate themselves much more into the world economy and strengthen their trade capacity. An important precondition for this closer integration is access to the markets of OECD countries as was acknowledged in the context of the Doha Round. The capacity to trade is, however, not only a challenge related to tariff and non-tariff trade barriers. In the era of globalisation, factor movements are an integral part of international economic relations. Policies in OECD countries that encourage e.g. FDI in developing countries can help to strengthen the trade capacity of these countries and reinforce the positive effects of trade liberalisation. The point to make here is that different policies of OECD countries can be mutually reinforcing in their beneficial effects on developing countries. The Centre has demonstrated these policy interlinkages in the context of the East Asian experience.

The countries of this region have been able to develop rapidly since the impact of OECD countries' policies was significant and largely positive in terms of growth stimuli and incentives and the countries themselves put in place the policy framework and institutional as well as human capacity to respond. OECD countries have been fostering policy coherence for development by:

- Helping to maintain political and macroeconomic stability conducive to private sector-led growth.
- Promoting an open and predictable international marketplace for goods and services on a multilateral and non-discriminatory basis, as well as orderly movement of people, complemented by trade-related assistance.
- Strengthening the governance structure for international investment and finance to facilitate the flow of capital and technology in developing economies and help maintain financial stability.
- Increasing the effectiveness of aid from both bilateral and multilateral donors through aid and harmonisation alignment with a focus on economic growth and capacity building, both human and institutional.

To Increase Financial Flows for Achieving the MDGs

It is commonly understood that current financial flows from OECD to developing countries are not sufficient to help achieve the MDGs by 2015. Policy makers in OECD countries have reacted to this challenge by focusing on two options: increase the volume and effectiveness of aid and suggest alternative approaches to funding the MDGs. The Centre has contributed to the debates on both issues. A reallocation of ODA flows towards the production of public goods could make ODA more effective in reaching the MDGs without jeopardising traditional development co-operation with poor developing countries. And, there are non-distorting options to increase financial flows that are additional to ODA, in particular in the area of financial engineering such as the International Finance Facility (IFF) or public guarantees. The latter appear to be very promising since they would foster a sense of ownership in recipient countries and allow the allocation of scarce resources to projects with potentially high returns. However, current discussions among 6-8 countries do not seem to indicate a lot of common ground on this question.

An obstacle to finding politically acceptable solutions to provide the necessary funding for MDGs is low public awareness of the MDGs and their implications. As long as only 12 per cent of all Europeans are familiar with the goals, there is hardly enough public pressure on politicians to come to an agreement. The Centre is, therefore, helping information officers from DAC Member countries to collect relevant data and to co-ordinate awareness campaigns in support of a better funding of MDGs.

Where Developing Countries Need to Take the Lead

Creating the capacity to embrace new opportunities and to initiate broad-based development is, of course, first and foremost a challenge for the institutions and policies of developing countries. They themselves have to design appropriate strategies to increase the competitiveness of their economies, mobilise the private sector, build institutions that can guide and strengthen market transactions, improve infrastructure, and tackle poverty. OECD countries can support national efforts by know-how transfer and financial assistance, but the initiative needs to come from developing country stakeholders in order to create ownership and responsibility. In this context, the Centre has focused on capital costs in developing countries, barriers to building competitive capacities and institutional prerequisites for poverty reduction.

To Promote Investment

Lowering domestic interest rates and, thus, the cost of borrowing is a priority to promote investment and economic growth. The rand zone (Lesotho, Namibia, Swaziland and South Africa) provides an example for designing policies that can help to reduce capital costs in the whole Southern African region as local currency interest rates in these countries are driven by rand-denominated transactions. Therefore, reducing the level and volatility of the rand premium has an impact on interest rates in all countries of the region. A lower and more stable rand premium would require enhancing financial market liquidity; easier access to South African financial markets for African entities; domestic saving capacity; and the improvement of international perception of the rand. With such policies in place, Johannesburg could become a financial "hub" for the region, channelling cheap resources to its neighbours.

To Build Competitive Strength

Raising manufacturing productivity is of central importance to the developing world and an essential element of policy making. Productivity growth results from improvements in infrastructure, physical capital, education and aggregate efficiency. These factors, when multiplied together, give a true picture of a country's situation in the productivity "league table". More than a simple comparison, this ranking system allows the identification of the key elements in each particular national or regional case which require most attention. The analysis shows that the main barriers to competitiveness in sub-Saharan Africa are the limited availability of infrastructure, in particular energy supply, and the low level of educational attainment. Such results do not mean, however, that other areas can be totally neglected; one of the main points for policy making is that all five elements have to be dealt with, if they are not to impact negatively on each other and, thus, hamper productivity gains that could contribute to the reduction of poverty and attainment of several of the MDGs.

For many poor countries in Africa and in other regions, commodity dependence is considered to be an obstacle to growth of manufacturing and export diversification. The Centre has shown, however, that natural resources are not necessarily a "curse" – that they do not condemn low-income countries to underdevelopment but can provide rather a basis for sustained export-led growth. Natural resource-based sectors have potential for export diversification. The OECD "mirror" trade data suggest that many different routes to diversification exist, including resource-based manufacturing and processing of primary products. However, these opportunities are not being exploited in many low-income countries. This is because export diversification is typically a slow process, and this process needs to be sustained by an appropriate and coherent strategy, characterised by a combination of vision, co-ordination and management of conflicting interests. Moreover, the analysis of trade support services in two African countries points to a mismatch between private sector needs and the services available to them as well as to a limited institutional development of the trade and investment support network. Though important to Africa, these lessons for trade capacity building are also relevant for other low-income countries in Asia and Latin America.

Finally, governance systems are – for various reasons described below – a major determinant of the volume and allocation of investment in developing and emerging economies. Scrutinising existing institutions of governance is, therefore, an important aspect of building and strengthening the international competitiveness of an economy. African countries have well understood this relationship and have introduced the African Peer Review Mechanism under the umbrella of NEPAD. A related effort is the African Economic Outlook, jointly prepared by the African Development Bank and the Centre. The Outlook provides a comparable analysis of external and internal drivers of development for all major African countries. It thus gives African institutions and African policy makers a yardstick for judging the effectiveness of policies implemented in different countries and an argument for promoting policy reform. To be credible, such an instrument of analysis needs to be owned by African institutions while OECD countries can help to build the required capacity.

To Strengthen and Adapt Institutions

It is by now generally understood that institutions have an important role to play in promoting economic development and making it pro-poor. Formal institutions and governance systems provide the framework for a functioning market economy and the supply of public goods. In developing countries there is however another layer of more informal institutions that should be taken into account if development is to become sustainable. These include family and kinship structures, traditions, as well as civil and social norms that are often summarised under the heading "culture". In the context of increasing competition and more frequent inter-cultural exchanges these traditional social institutions can help or they can hinder the emergence of new economic and social opportunities.

One such aspect of culture is how societies treat women. The Centre has shown that there are strong inter-regional disparities. On average, gender discrimination is less pronounced in East Asia and Latin America compared with sub-Saharan Africa, South Asia and the MENA region. Secondly and more importantly, religion is not the major determinant of gender inequality, suggesting a degree of freedom within leading religions to define the role of women differently. Finally, and not surprisingly, an institutional framework that disadvantages women hinders development because it governs the possibilities of half of the population for participation in economic activities.

Adapting social institutions to the challenges of economic development requires the willingness of the government to challenge traditions and privileges that have been in existence since centuries. A successful improvement of the situation of women is not possible by focussing solely on improvements in female education, health care and access to credit markets. These measures are important, but they need to be accompanied by changing discriminatory habits and practices, both at the national and the community levels. If girls are traditionally not allowed to leave the house, a girls' school will hardly be of much help.

How informal and formal institutions are intertwined and can determine the outcomes of policy reform has also been demonstrated with respect to regional decentralisation of policy making. Decentralisation is receiving increasing international attention as a potential tool for poverty reduction. However, the Centre did not find a clear link between decentralisation and poverty reduction. On the contrary, in some of the poorest countries characterised by weak institutions and political conflicts, decentralisation could actually make matters worse. Two important policy lessons emerge from this finding: First, in an environment where the central state hardly fulfils basic functions and is not interested in giving more power and resources to local tiers of the government, decentralisation should not be a priority for donors as it could be rather counter-productive with respect to the objective of poverty reduction. Secondly, in countries that fulfil basic prerequisites, decentralisation could be a powerful tool for poverty reduction. Pro-poor decentralisation requires a clear understanding of the key factors influencing the process itself, i.e. the informal institutions governing behaviour at sub-national levels.

However, not only informal and formal institutions are interrelated; the same also holds for relations among formal institutions. One such important example is the mutual interdependence of corporate and political governance. Corporate governance has a crucial role to play in today's developing, transition and emerging market economies. In poor countries as in middle-income countries, in countries that have few companies with widely traded shares as in countries that have many, corporate governance is needed to help increase the flow and lower the cost of the financial capital that firms need to finance their investment in real assets, to enhance liquidity in the country's economy as a whole and to achieve long-term productivity growth. Forces working in favour of improved corporate governance include corporations whose extra-firm financial needs have grown, and major institutional investors, especially pension funds and other long-term investors, based in OECD countries and, increasingly, in the developing, transition and emerging-market economies themselves. Forces working against significantly improved corporate governance include many dominant shareholders and other corporate insiders – operating in the private and public sectors alike – who often constitute entrenched distributional cartels. Particularly problematic is also the extent to which cross-shareholdings, multiple share-classes, and especially pyramidal corporate ownership structures are used to generate corporate-control rents.

The importance of distributional cartels in developing countries, as obstacles to development as well as to improved corporate governance, and the heightened risk of regulatory capture in countries with clientelistic relationship-based systems of governance only reinforce the fact that good corporate governance requires good political governance, and vice versa. Development requires moving from the rule of persons to the rule of law, in the institutions of corporate and political governance together. The objective must be to create a governance culture that facilitates the production and sharing of trust, power and information for the benefit of all. Achieving this objective requires a process of rule setting and institution building which, especially in poorer developing countries, may best be sustained in the context of public focal monopoly governance systems as an intermediate step.

Annex: **List of Publications Resulting from the 2003-2004 Work Programme**

(* indicates the manuscript has not yet been received)

I. Trade, Competitiveness and Adaptive Capacity

Author	Title	Type	Date
	Studies		
A. Goldstein	Regional Integration, FDI and Competitiveness: The Case of SADC	Policy Study	Jul-04
K. Fukasaku	The Impact and Coherence of OECD Country Policies on Asian Developing Economies (English only)	Policy Study*	Q2/05
		Policy Insight	Jan-05
K. Fukasaku and E. Dohlman	Trade Capacity Building and Private Sector Development: Lessons from Developing Asia	Policy Study*	Q3/05
D. Cohen and O. Causa	Competitiveness Indicators: Results and Conclusions	Policy Study*	Q3/05
	ditto	Policy Insight*	Q3/05
	Policy Briefs		
K. Fukasaku, H. Kawai, M. Plummer and A. Trzeciak-Duval	Policy Coherence Towards East Asia: Development Challenges for OECD Countries	No. 26	Jan-05
	Policy Insights		
S. Urata	Towards an East Asian Free Trade Area	No. 1	March-04
	Working Papers (only available in the original language)		
F. Bonaglia and K. Fukasaku	Export Diversification in Low-Income Countries: An International Challenge After Doha	No. 209	June-03
R. Pomfret	Central Asia since 1991: The Experience of the New Independent States	No. 212	Jul-03
M. Bussolo and J. Whalley	Globalisation in Developing Countries: The Role of Transaction Costs in Explaining Economic Performance in India	No. 219	Nov-03
M. Bussolo and J.I. Round	Poverty Reduction Strategies in a Budget-Constrained Economy: The Case of Ghana	No. 220	Nov-03
M. Bussolo and J. Lay	Globalisation and Poverty Changes in Colombia	No. 226	Dec-03
J. Dayton-Johnson	Natural Disasters and Adaptive Capacity	No. 237	Jul-04
D. Cohen and O. Causa	Overcoming Barriers to Competitiveness	No. 239	Dec-04
F. Bonaglia, K. Fukasaku, C. Lesser and J. Anderssen	Trade and Structural Adjustment: Development Perspectives	Forthcoming*	Q3/05

II. Finance for Development

Author	Title	Type	Date
	Studies		
C. Oman	Corporate Governance in Development: The Experiences of Brazil, Chile, India, and South Africa	Policy Study	Oct-03
M. Flandreau and F. Zumer	The Making of Global Finance 1880-1913	Policy Study	May-04
N. Meisel	Governance Culture and Development: A Different Perspective on Corporate Governance	Policy Study	Jul-04
	ditto	Policy Insight*	Q2/05
C. Oman and N. Meisel	Institutional Investors: A Key to Better Governance	Policy Study*	Q3/05
	ditto	Policy Insight*	Q2/05
M. Grandes, N. Pinaud	Reducing Capital Cost in South Africa	Policy Study*	Q2/05
J. Winpenny	Guaranteeing Development? The Impact of Financial Guarantees	Policy Study	Q2/05
	Policy Briefs		
C. Oman, S. Fries and W. Buiter	Corporate Governance in Developing, Transition and Emerging-Market Economies	No. 23	Dec-03
H. Reisen	Innovative Approaches to Funding the Millennium Development Goals	No. 24	Apr-04
M. Grandes and N. Pinaud	Understanding Debt Costs in South Africa: What Policies Could Narrow the Spread?	No. 25	Sept-04
D. Cohen	Post HIPC Agenda	Forthcoming*	Q3/05
	Policy Insights		
D. Cohen	In Favour of a Fund to Hedge Poor Countries against Commodity Shocks*	Forthcoming	Q1/05
	Working Papers (only available in the original language)		
A. Goldstein	The Political Economy of Regulatory Reform: Telecoms in The Southern Mediterranean	No. 216	Nov-03
J. Braga de Macedo and H. Reisen	Float in Order to Fix? Lessons from Emerging Markets for EU Accession Countries	No. 218	Nov-03
H.-B. Solignac Lecomte	Building Capacity to Trade: What Are the Priorities?	No. 223	Dec-03
M. Grandes, M. Peter and N. Pinaud	The Currency Premium and Local-Currency Denominated Debt Costs in South Africa	No. 230	Jan-04
M. Grandes	Macroeconomic Convergence in Southern Africa: The Rand Zone Experience	No. 231	Jan-04
H. Reisen, M. Soto and T. Weithöner	Financing Global and Regional Public Goods through ODA: Analysis and Evidence from the OECD Creditor Reporting System	No. 232	Jan-04
H. Reisen, M. Grandes and N. Pinaud	Macroeconomic Policies: Issues of Interdependence	No. 241	Jan-05
L. McKellar	Priorities in Global Assistance for Health, AIDS and Population (HAP)	No. 244	Q2/05
N. Meisel, C. Oman and C. Arndt	Uses and Abuses of Governance Indicators	Forthcoming*	Q3/05

III. Social Institutions and Dialogue

Author	Title	Type	Date
	Studies		
I. Mc Donnell, H.-B. Solignac Lecomte and L. Wegimont	Public Opinion and the Fight Against Poverty	Policy Study	May-03
H.-B. Solignac Lecomte and I. Smillie	Ownership and Partnership: What Role for Civil Society in Poverty Reduction Strategies?	Policy Study	Dec-03
S. Borner, F. Bodmer and M. Kobler	Institutional Efficiency and its Determinants: The Role of Political Factors in Economic Growth	Policy Study	Febr-04
	Policy Briefs		
N. Pons-Vignon	Land, Conflict and Development: What Role for Donors?	Forthcoming	
		Policy Insight*	
J. Jütting and C. Morrisson	Changing Social Institutions to Improve Women's Conditions in Developing Countries	No. 27	July-04
J. Jütting and J. Davies	ditto	Policy Insight*	Q2/05
N. Pinaud and H.-B. Solignac Lecomte	Public-Private Dialogue in Africa	Forthcoming*	Q3/05
		Policy Insight*	Q3/05
	Policy Insights		
J. Fransman and H.-B. Solignac Lecomte	Mobilising Public Opinion against Global Poverty	No. 2	Avr-04
J. Jütting, E. Corsi and A. Stockmayer	Decentralisation and Poverty	No. 5	Jan-05
	Working Papers (only available in the original language)		
J. Jütting	Institutions and Development: A Critical Review	No. 210	Jul-03
L. Breierova and E. Duflo	The Impact of Education on Fertility and Child Mortality: Do Fathers Really Matter Less than Mothers?	No. 217	Nov-03
J. Braz	Public-Private Partnerships in Development: Three Applications in Timor Leste	No. 221	Dec-03
I. Mc Donnell, H.-B. Solignac Lecomte and L. Wegimont	Public Opinion Research, Global Education and Development Co-operation Reform: In Search of a Virtuous Circle	No. 222	Dec-03
R.J. Tibana	The Composite Indicator of Economic Activity in Mozambique (ICAE): Filling in the Knowledge Gaps to Enhance Public-Private Partnership (PPP)	No. 227	Dec-03
H.-B. Solignac Lecomte and N. Pons-Vignon	Land, Violent Conflict and Development	No. 233	Feb-04

Author	Title	Type	Date
J. Jütting	The Impact of Social Institutions on the Economic Role of Women in Developing Countries	No. 234	May-04
C. Morrisson	La condition des femmes en Inde, Tunisie, Kenya et Soudan	No. 235	Jul-04
J. Jütting, C. Kauffmann, I. Mc Donnell, H. Osterrieder, N. Pinaud and L. Wegner	Decentralisation and Poverty in Developing Countries: Exploring the Impact	No. 236	Aug-04
J. Fransman, I. Mc Donnell, H.-B. Solignac Lecomte, A. MacDonald	Public Opinion Polling and the Millennium Development Goals	No. 238	Oct-04
S. Dercon, T. Bold, J. de Weerdt and A. Pankhurst	Extending Insurance? Funeral Associations in Ethiopia and Tanzania	No. 240	Nov-04
D. Narayana	Institutional Change and its Impact on the Poor and Excluded: the Indian Decentralisation Experience	No. 242	Sept-04
H. Uchimura	Impact of Changes in Social Institutions on Income Inequality in China	No. 243	Q2/05
J. Fransman	Beyond NGOs: The Elusive Realm of Civil Society	forthcoming*	Q2/05
N. Pinaud	Le dialogue public-privé dans les pays en développement : risques et opportunités	forthcoming*	Q3/05

IV. African Economic Outlook

Author	Title	Type	Date
	Studies		
AEO Team	AEO Volume 2	Policy Study	March-03
J.-C. Berthélemy, C. Kauffmann, M.-A. Valfort and L. Wegner	Privatisation in Sub-Saharan Africa: Where Do We Stand?	Policy Study	Feb-04
AEO Team	AEO Volume 3	Policy Study	Jul-04
	Policy Insights		
C. Kauffmann	Energy and Poverty in Africa	No. 8	Q2/05
C. Kauffmann and L. Wegner	Privatisation in Sub-Saharan Africa: Where do We Stand?	Policy Insight*	Q3/05
	Working Papers (only available in the original language)		
J.-C. Berthélemy, C. Kauffmann and L. Wegner	Political Instability, Political Regimes and Economic Performance in African Countries	Working Paper*	Q4/05

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