

# Global Development Strategy and Japan's ODA Policy

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The recent World Bank-driven development strategy regards poverty reduction as the primary goal and emphasizes partnership, transparency, accountability, capacity building, empowerment, etc. There is also pressure to redirect the shrinking global ODA funds to the poorest countries willing to adopt “international best practices.” As the largest ODA donor, Japan participates in this global aid approach with considerable unease. The majority of Japanese development officials and economists think the World Bank approach imposes too much procedural uniformity while disregarding local diversity and real-sector concerns including the promotion of nascent industries under international integration. With its own ODA budget on the decline, the Japanese government is currently reviewing its ODA strategy. While some urge acceptance of the World Bank strategy as Japan's own, this paper proposes an alternative objective: sustaining *Asian dynamism*—unique regional growth pattern fueled by close trade and investment ties. This must be pursued in a way that does not exclude economies outside East Asia. External economic policies including ODA, trade and investment should be redirected primarily toward this goal, while globally common concerns such as poverty and environment should be pursued as an important supplementary goal. Under this framework, Japan's existing aid portfolio can be reinterpreted, justified and expanded. Japan's dual position as a member of Asia as well as developed countries will also be easier to manage and reconcile.

## 1. Introduction

Absence of clear principles that can be projected to the rest of the world as well as slow and passive reaction to shifting external circumstances are the salient features of Japanese diplomacy after World War II. These features are surely visible in Japan's ODA policy. While this follower attitude adopted by a huge economic power such as Japan may have lessened potential tension in the Asia-Pacific region, it inevitably leads to the accusation that Japan is not assuming the leadership role commensurate with its economic size.

In Japan, there is always bitterness that Japan's monetary contribution to the world, *which is huge*, is not properly appreciated by the global community. This chagrin permeates Nagatacho (political center) and Kasumigaseki (bureaucratic complex) as well as the business community and the media at large. The reason for under-appreciation is thought to be the lack of attractive diplomatic goals into which funds can be poured as well as poor public relations effort. The Japanese government wants to present "assistance with a visible face." Requiring to post a Japanese ODA logo on all cardboard boxes and structures donated by Japan is a desperate attempt in this direction, but that seems hardly enough or to the point.

At present, Japan's ODA policy is under critical review for two major reasons. The first is fiscal crisis that forces the government to cut expenditures that are not deemed absolutely necessary. The ODA budget, previously regarded as *sacred*, is now certain to shrink in the future and the only question is which items and by how much.<sup>1</sup> Surely, ten years of economic recession has done much to prompt these unfavorable changes. Under fiscal austerity, re-examination of past formulae is unavoidable. Also from the viewpoint of ODA executing bodies, a new vision is needed to minimize the damage and preserve their *raison d'etre*.

The second reason for ODA review is external. During the last decade as Japan emerged as No.1 supplier of ODA, Japanese officials and economists voiced their opinions more loudly than ever and the World Bank also began to listen. Closer cooperation and mutual learning between Japan and the Bank have been promoted and produced positive results, which should not be understated. Nevertheless, in fundamental policy orientation, Japan and the Bank do not seem to have narrowed the gap significantly even after ten years of intensive policy dialog. *Comprehensive Development Framework*, the World Bank's bold and most recent initiative, is as alien to the Japanese ODA community as neoclassical development economics was in the 1980s. This powerful reorientation of development strategy initiated by World Bank President James Wolfensohn is plunging the Japanese aid

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<sup>1</sup> The government's budgetary guideline announced on August 10, 2001 was to cut the ODA budget by 10 percent in FY2002.

officials into the usual ambivalence between followership and silent disapproval.

This paper will discuss Japan's current attempt to move away from the traditional reactive mode and project its own ideas more strongly in ODA policy making. The next section describes how Japan is cooperating with the World Bank's new development initiative, so far passively and without much enthusiasm. At the same time, there are many attempts to re-make Japan's own development strategy. After a brief review of these attempts, the second half of this paper will present an alternative proposal. At this moment, whether Japan will succeed in finding a new ODA vision very soon is difficult to tell.

It must be warned at the outset that views contained here are neither impartial nor comprehensive due to the author's involvement in the Japanese ODA debate as practitioner as well as advisor to the government. This paper depends heavily on ongoing research organized separately by METI and JICA.

## 2. Japanese Reaction to the New Trends

### Shifting Ideas in Development Economics

Development economics, as a policy-oriented discipline for improving the material being of people residing in the developing world, was invented after World War II as former colonial territories collectively gained political independence. Since then, roughly for half a century, many models and paradigms were proposed for diagnosing various questions in the developing world.

In the early postwar period, development economics was mainly concerned with socio-economic engineering aspects such as the savings-investment balance, choice of technology, material planning, etc. Poverty was often attributed to inappropriate social structure, such as rigidities and segmentation of labor and land markets (*structuralism*). In the 1970s, global political movement which attributed poverty to forced inequalities between the developed and the developing world accelerated (*politicization of the North-South problem*). The developing countries accused the industrialized world for imposing "unfair" trade and "invasion" by multinational corporations, and demanded establishment of the New International Economic Order based on affirmative actions and significant transfer of wealth in favor of developing countries.

Throughout much of the 1950s, 60s and 70s, official activism was deemed essential for correcting both domestic rigidities and international injustice. Governments in the developing world often adopted economic planning and nationalized key industries. In those days, government intervention flourished not only in socialist China and USSR, but also in other developing areas including South Asia and Sub-Saharan Africa. Over time, however,

development strategy based on naïve optimism on the role of the government inevitably led to economic inefficiency and stagnation. Except for a number of countries including Japan and East Asian NIEs which used official intervention with light touch and sufficient care [World Bank 1993], heavy official intervention failed spectacularly as a means to catch up with the West. Dismay and reflection followed, producing two main currents in development economics which dominated the policies of the World Bank and IMF during the last quarter of the 20th century—even to date.

The first trend is economic liberalism which either negates or significantly reduces the useful role of government in the development process. According to the radical proponents of neoclassical development economics, the key to economic success consists of removing official intervention and unleashing market forces as fully and quickly as possible, regardless of initial conditions and development stage. Externally, bold trade and investment liberalization must be accomplished. Since the 1980s, this radicalism—or orthodoxy, depending on one’s standpoint—has guided the actual policy conditionalities of the World Bank and IMF imposed on developing countries seeking their financial assistance to execute “structural adjustment.”

The second trend is a rising interest in microeconomic and institutional aspects of development, rather than (or in addition to) macroeconomic concerns. Optimism of the early postwar period that economic growth will naturally eliminate poverty (“trickle-down hypothesis”) is now strongly rejected; instead, direct attack on poverty has been elevated to the primary goal as well as the most effective means of development. Today, all strategies and projects must be evaluated in this light. Furthermore, all countries are required to address the questions of environmental protection, administrative efficiency, creation of participatory process and civil society, etc. even in the early stages of development. It is no longer permissible to wait until economic growth will gradually solve these social and political questions in the future. Positive actions on all these fronts are required now, or you are out.

### Global common sense and Japanese dissent

The current Western thinking on economic development (as embodied in the actual policies of international financial organizations) can be summarized as follows [Izumi Ohno 2000].<sup>2</sup>

- *The ultimate objective of development is poverty reduction. This encompasses not just rising income, but also the regaining of human quality such as dignity, security, voice and choice by all people. Development assistance should be evaluated mainly by the amount*

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<sup>2</sup> Here, the West particularly means the Anglo Saxon and Nordic countries. They seem to be leading the global development debate and are most comfortable with the recent trends.

*of contribution to this goal.*

- *Economic development (i.e., poverty reduction) requires a wise government. To build it, administrative capacity must be enhanced by intense institutional reforms. In particular, transparency, accountability, good governance and promotion of civil society are among the goals for which all governments should strive.*
- *The private sector should be deregulated and given a level playing field. Government should not do what the private sector can do. As to official intervention for industrial promotion, a few countries may implement it successfully, but it is too difficult for most countries. General economic liberalization combined with open door policy is suitable for the vast majority of countries.*
- *As to countries unable to implement “correct” policies with ownership, policy advice should be given, not financial assistance.*
- *Development must proceed in a cooperative framework involving all stakeholders inside and outside the country. Piecemeal policies and assistance will not produce results.*

These ideas are typically represented by the *Comprehensive Development Framework* (CDF), a new assistance strategy by the World Bank.<sup>3</sup> In essence, CDF is a permanent country forum set up by government, private businesses, NGOs, donor countries and international organizations for discussing and allocating development tasks in both economic and non-economic fields. At present, CDF has been adopted in 12 pilot countries (in East Asia, Vietnam is the only country implementing this approach).

Whether this approach will turn out to be the ultimate solution, an important step forward, or just another fad in development aid to be largely forgotten several years later, remains to be seen. Many Japanese development officials and economists are skeptical.<sup>4</sup> While Japan has been the largest donor in development assistance since the early 1990s, it has kept its distance from the dominant development thought emphasizing economic liberalization and poverty reduction. Usual criticisms hurled at the dominant view include

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<sup>3</sup> At the Bank-Fund Annual Meetings in October 1998, World Bank President James Wolfensohn argued that good macroeconomic management was necessary but not sufficient for economic development, and proposed the “Comprehensive Development Framework” incorporating social and environmental needs and emphasizing institution building. CDF also calls for broad participation of civil society, NGOs, private businesses, government, donors, etc. In September 1999, the Bank and the Fund decided to require a “poverty reduction strategy paper” (PRSP) from any country that receives concessional financial support. Roughly speaking, CDF is a general principle while PRSP is a document that concretizes the poverty reduction strategy for each country. The updated details can be obtained from the World Bank’s website.

<sup>4</sup> Certainly, this should not be taken to imply that *all* Japanese economists and officials are critical. There are many who are dedicated to or think highly of the recent global aid strategy. Still, it is undeniable that, *relatively speaking*, Japan is much more skeptical than the US or EU.

the following:

- *Current development strategies are too uniform across countries.*
- *Apparently “pro-poor” policies may not be the best way to reduce poverty in the long run.*
- *Liberalization and legal framework alone will not be sufficient to create a market economy from scratch.*
- *International integration of latecomer countries must be implemented more carefully.*

It is not that Japan wants to deny every aspect of the dominant development thinking. In fact, there are many things Japan can learn from it. However, as a non-Western country with different developmental experience of its own, Japan should be able to contribute more to global development thinking through constructive criticism rather than uncritical endorsement. Japan should also offer a dissenting view when Western systems are hastily imposed on a society with entirely different history and social structure from the West.

More specifically, there seem to be three major bones of contention between Japan and the dominant view: they are concerned with *poverty*, *market*, and *integration*. We discuss them in turn below.

#### Questions about poverty

In the Western donor countries and international organizations such as the World Bank, UNDP, ADB, etc, poverty reduction as the primary purpose of economic development is now accepted as a self-evident proposition. The definition of poverty has also been expanded from the simple numerical poverty line of one dollar per head a day, to include social dimensions such as literacy, infant mortality, medical access, clean water etc. More recently, *empowerment*—whether the poor themselves are the master of the development process—became the buzzword. It is true that very few of us can suppress the feeling of sympathy and charity when viewing destitute people deprived of basic human rights on TV. But this and the argument that both the purpose and the means of development must solely be helping the poor are two separate issues.

In ODA policy debate, the Western countries no longer seem to be enthused over building industrial infrastructure such as roads, ports and power plants. Certainly these are not “pro-poor” projects and, at any rate, they should be financed with private money, not ODA. True, in middle-income countries with improving institutions and sufficient industrialization, infrastructure development on a commercial basis should be both possible and desirable. But there are also many poorer countries whose infrastructure is absolutely lacking and markets are undeveloped. Unfortunately, for those most critical countries private-sector initiative in infrastructure construction, whether domestic or foreign, is hardly forthcoming. To reduce poverty, it is not immediately clear whether improving hygienic conditions is a better use of

aid money than building a trunk road; the conclusion should depend on each case. “See poverty, lend a hand” is emotionally appealing but perhaps shortsighted as a long-term development strategy. If too much attention is paid to the poverty in sight, we may run the risk of neglecting other important tasks for overall growth, which are the prerequisite for poverty reduction.<sup>5</sup> Industrial promotion may be out of fashion in Washington, but its proper execution is absolutely necessary for sustained development.

In historical retrospect, economic development has always been a highly politically charged process in which each nation-state aims to bolster its autonomy and influence against the prevailing international pecking order of each age. Prussia and Japan in the 19th century as well as postwar Korea and Taiwan were all driven by strong nationalism to catch up with the leading nations, not by the goal of poverty alleviation. Social achievements including poverty reduction were realized in the long run as a consequence of successful industrialization. It is highly unlikely that latecomers in the 21st century will achieve sustained growth with pro-poor policies alone, if wise industrial promotion strategy is missing.

#### How to generate a market economy

The second issue over which Japan often disagrees with the dominant view is related to systemic transition. It is now widely noted that the big-bang privatization in the former Soviet bloc failed dramatically (or to put it more mildly, did not yield the anticipated results). Poland, Hungary and Baltic countries were previously integrated with and constituted a part of European civilization. For them, systemic transition meant revitalization of the market system which existed in the past. To the east, however, virtually all of the former Soviet republics had no market experience to speak of in their history and thus were unable to create a market economic system simply by deregulation and privatization. Transition to market is relatively easy or almost impossible, depending on the historical conditions of individual countries.

This conclusion was already clear to the majority of Japanese economists from the very beginning [Ohno & Ohno, 1998]. But the Japanese criticism was too weak to influence the dominant view. During much of the 1990s, international organizations and Western consultants continued to blame the Russian stagnation on either political instability or initial economic structure, rather than their policy prescription [Lipton and Sachs 1992, Sachs and Woo 1994]. After nearly a decade of very mixed transition results, some Western economists

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<sup>5</sup> Shigeru Ishikawa, the leader of JICA’s intellectual ODA to Vietnam 1995-2001 as well as chairperson of *Enshakkan Kondankai* (see below), warns that in an effort to implement CDF and PRSP, Vietnam’s budget may become excessively biased toward “pro-poor” expenditures at the cost of other economic needs including infrastructure building.

have finally begun to echo Japanese common sense [for example, Stiglitz 1998]. They argue that systemic transition of a latecomer country will take a long time. In such a country, markets can grow only as a result of slow evolution of private businesses, which must be appropriately supported by official action. There is no guarantee that this lucky event will occur in all developing or transition countries.

Even today, however, neoclassical liberalism in development and transition is still in the majority. Belief that removal of control will automatically generate a market economy is still held strongly. In other words, the proponents of this view consider “wrong policies” as the prime cause of economic stagnation in the past. As a matter of principle, the World Bank and IMF continues to advise fast and bold liberalization and external integration to all member countries, regardless of levels of industrialization or competitiveness. In Sub-Saharan Africa also, the current aid strategy is simultaneous elimination of *economic control* and *external debt*, the two negative legacies of the past. After these are removed, African economies are expected to take off.

Are these policies correct? The majority of Japanese development economists remain unconvinced. In their view, simple removal of “wrong policies” will not create healthy markets in the poorest or transition economies of today. These economies remain underdeveloped precisely because they lack basic conditions for creating a market economy, including sufficiently high productivity (especially in agriculture), distribution system, political and social stability, observance of contracts, mutual trust, long-term perspective, etc. Some of these inadequacies may have been imposed during the colonial days, but many others date further back in history and are deeply engraved in the society. From the cultural or spiritual viewpoint, these are unique social characteristics that must be preserved. But they may hinder a more materialistic goal of economic development.

For latecomer countries aspiring to industrialize and raise income, tactful merger of domestic base society and incoming foreign systems—which are often at odds with what already exists—is required. There should be different modes of merger reflecting the differences in history and social structure. This will inevitably be a long process strewn with many setbacks. The idea that market creation is tantamount to replacing past policies with international best practice is too naïve.

### Globalization and LDCs

As a key economic policy component, developing countries are being asked to integrate rapidly with the global market economy in a large number of fields including goods, services, investment, capital, information and institutions. This pressure has accelerated during the post Cold War period, as the USSR disappeared and the US-centered unipolar order emerged. Not only highly and moderately developed countries but also the poorest and



transition countries are striving to integrate in trade, investment, law and other systems as a prerequisite for participating in the world economy. From this perspective, the role of international organizations such as the World Bank, IMF and WTO is to support (and sometimes force) the globalization of latecomers with appropriate carrot and stick.

However, industries, policies and institutions of latecomer countries remain very weak while the world economy into which they are jumping is highly competitive and unstable. Unprepared integration often leads to economic crisis and loss of national identity. While developing countries must make utmost effort to integrate, it must proceed in a way that preserves the ownership and continuity of domestic society rather than destroys it. This naturally requires lots of caution and an element of gradualism. It appears that, under excessive integration pressure, many latecomers are unable to become the master of their own fate.

From this perspective, the Asian crisis was a severe macroeconomic shock lasting for a few years caused by LDCs' inability to properly sequence the capital liberalization process. When domestic banking is unsound and its monitoring mechanism is not in place, bold financial opening led to overborrowing and its eventual reversal, resulting in the loss of macroeconomic control. IMF should share the blame not only for encouraging such reckless opening but also for the clumsy policy response after the crisis erupted [Yoshitomi and Ohno 1999]. At present, international organizations are not always benevolent promoters of LDCs' globalization.

Trends of liberalization and integration are likely to continue in the early 21st century. Under the circumstances, management of international integration must be the central policy issue in economic development. Review of the current integration rules must be undertaken by both developing and developed countries, especially the latter as builders of international order.

### 3. Searching for a New ODA Principle

#### Developments since the Asian Crisis

Recently, Japanese external economic policies have shifted. These policy shifts may significantly reshape Japanese ODA in the near future.

First, Japan has abandoned its sole reliance on multilateralism and begun to use regional and bilateral channels as additional means of economic diplomacy. Traditionally and until only a few years ago, Japan strongly supported multilateral systems including the World Bank, IMF and WTO and remained very skeptical about bilateral and regional schemes. Even when APEC was created in 1989, Japan emphasized its feature as open regionalism [Suehiro

and Yamakage 2001]. Since around 1999, however, Japan became increasingly willing to accept regionalism and bilateralism. In trade, disappointment with the slowness of WTO's new round talks prompted Japan to diversify its diplomatic channels. It started to vigorously negotiate bilateral free trade agreements with Singapore, Korea, Mexico, Chile and Australia (progress varies; the agreement with Singapore is expected by end 2001). The METI White Paper [METI 2001] argues that the use of multiple channels facilitates (i) creation of new trade rules; (ii) sustaining momentum for multilateral talks; (iii) accumulation of experience; (iv) removal of demerits associated with having no bilateral agreements; and (v) domestic structural reforms. However, whether deviation from multilateralism accelerates or hinders global trade in the long run remains unsettled—as METI [2001] itself recognizes.

Second, the Asian crisis further stimulated Japan to act more independently from the US and international organizations. Perceived arrogance and incompetence of IMF at the time of the crisis forced Japan to build alternative safety nets in cooperation with Asian neighbors. The crisis countries also strongly requested Japan to provide additional aid. After the idea of the Asian Monetary Fund was shot down by the US in November 1997, Japan moved swiftly to provide bilateral assistance to the crisis countries including through New Miyazawa Plan and Japan Special Fund, in addition to large contributions to the IMF-negotiated packages. According to Suehiro [2001], these emergency measures bore the characteristics of (i) supply side emphasis; (ii) intellectual cooperation (i.e., policy advice); and (iii) building regional networks. The first—real-sector concern—is not new, but the other two reflect Japan's struggle for more independent and regionally based policies. ASEAN+3 as well as Chiang Mai Initiative for central bank cooperation also serve to promote more policy independence for the region.

Third, somewhat contrary to these developments, Japan is becoming less tolerant with surging imports from Asia (especially China) and turning more protectionist. After a decade-long recession, weakened domestic producers and threatened workers naturally clamor for higher import barriers. In 2001, the government became more sympathetic with these producers by seriously considering safeguard measures and actually imposing some of them (see below). However, this policy was severely criticized by economists as well as export-oriented industries, and immediately greeted with retaliatory measures from China.

As always, the interests of outward-looking ministries (MOF, METI, MOFA) and other ministries do not coincide, and this may explain the seemingly contradictory policies of cooperating with Asia and refusing Asian goods simultaneously. Moreover, Japanese relations vis-à-vis ASEAN, characterized by economic dominance, unilateral assistance and relative lack of political disputes, should be distinguished from that with China which is more equal and complex.

## Proposals for ODA reform

From the late 1970s to the mid-1990s, the Japanese government placed high priority on expanding ODA by pursuing ambitious numerical targets. The First ODA Medium-term Goal in 1978 aimed to double ODA in three years. Similar aggressive targets were set in the Second (1981), Third (1985), Fourth (1988) and Fifth (1993) ODA Medium-term Goals. Thanks to these efforts, Japan became the number-one donor in 1989 and has maintained its status since 1991. However, as the decade of prolonged economic recession compels the government to reduce ODA budget, the need to strategically prioritize Japan's ODA is called for in order to ensure its effective implementation. Recent proposals for ODA reform include the following:

(1) *Nijuisseiki ODA Kaikaku Kondankai* (The Advisory Committee for ODA Reform toward the 21st Century, an advisory body to the Minister of Foreign Affairs, chaired by Sabura Kawai of IDCJ, the final report published in January 1998).

This committee urged the government to shift ODA policy from quantitative expansion to qualitative improvement. Mindful of fiscal constraints, the committee proposed to replace the conventional numerical goals with the medium-term ODA policy framework. It also proposed clear prioritization of ODA allocation, paying greater attention to social development and poverty reduction as well as environmental and gender concerns. While the support for infrastructure development remains important, due attention should be given to complementarities between ODA and non-ODA funds. The committee further recommended the government to: (i) formulate country-specific assistance strategies; (ii) enhance coordination among various ministries and aid agencies with MOFA playing the coordinating role; (iii) broaden the support base in the Japanese society by inviting the participation of various stakeholders and increased information disclosure; and (iv) build the capacity of aid professionals, particularly in policy, institutional, and social aspects. Following these recommendations, the medium-term ODA policy was formulated in August 1999, with the objective of setting a guiding principle of ODA operations for the next five years.

(2) *Enshakkan Kondankai* (The Advisory Committee for ODA Loans, an advisory body to the Director General of the Economic Cooperation Bureau of MOFA, chaired by Prof. Shigeru Ishikawa, the final report completed in August 2000)

This committee focused on ODA loans and recommended four priorities and 26 specific measures to enhance their efficiency and effectiveness. While guided by the above ODA Reform Committee (1998) and Medium-term ODA Policy (1999), this report also took note of intensified debate over the assistance to HIPC's (especially the Enhanced HIPC Initiative agreed at Koln Summit in June 1999). The four priorities proposed by the

committee included: (i) selective provision of ODA loans based on strategic concerns such as effective and efficient use of ODA loans by recipient countries (i.e., shifting focus from debt-ridden Sub-Saharan Africa to Asia), availability of private resources for infrastructure development at various stages of development etc; (ii) addressing diverse needs of recipient countries with due consideration of their stages of development and balance between infrastructure and social development; (iii) active participation in aid coordination, reinforced effort in intellectual aid, aid coordination network, and capacity building of Japanese aid professionals; and (iv) strengthening accountability and public disclosure of ODA operations.

(3) *Seisaku Koso Forum Paper* (July 2001)

The Forum for Policy Innovation published a paper entitled “Need to Formulate the National Strategy for ODA.”<sup>6</sup> Citing the lack of strategic vision and a coherent institutional framework for ODA operations, the paper proposed reforms in three areas: (i) increasing the participation of various stakeholders of Japanese ODA; (ii) shifting the focus to international public goods such as poverty reduction and environmental protection, (iii) improving the quality of ODA through intellectual aid, country assistance strategies, and active adoption of “international best practices”; (iv) strengthening strategic planning capacity by establishing International Development Agency and/or Strategic Council for ODA under the Prime Minister’s Office, and developing the capacity of aid professionals.

(4) *Dainiji ODA Kaikaku Kondankai* (The Advisory Committee for the Second ODA Reform, chaired by Prof. Toshio Watanabe, the interim report published in August 2001, ongoing)

The Second ODA Reform Committee was launched in May 2001 to make recommendations on the effective and efficient implementation of ODA in the context of tighter budget constraints. While its final report is to be published in November/December 2001, the interim report highlights the following priorities: (i) increasing participation and transparency in ODA operations; (ii) making country assistance strategies more selective, with clear prioritization; (iii) more strategic, coherent, and coordinated institutional framework by establishing Council for Comprehensive ODA Strategy under MOFA; and (iv) strengthening collaboration with international organizations and sharpening the focus of bilateral ODA into the areas where Japan has comparative advantage.

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<sup>6</sup> The Forum for Policy Innovation is organized by academic professionals in social sciences for the purpose of making pragmatic policy proposals. This paper is based on the work by Prof. Masahiro Kawai (former chief economist of the World Bank’s East Asia-Pacific Region and currently an advisor to Vice Minister of International Affairs of MOF) and Prof. Shinji Takagi (Osaka University, former IMF economist).

Additionally, in a discussion memo presented to the METI's study group on Asian Dynamism, Kimura [2001] proposes to divide ODA into two categories: the one for East Asia and the other for poor countries outside East Asia. In East Asia, Kimura urges Japan to use commercial and aid policies for conducting *regional industrial policy* so as to deepen regional integration. Unilateral aid giving should be replaced by mutual cooperation on a more equal footing as the majority of Asian countries rise to the status of middle- to high-income countries by 2020. For countries remaining desperately poor in the rest of the world, Japan will have to choose between continuing to (pretend to) support their industrial development and confining its ODA to humanitarian aid only, assuming that they will never be active players in global competition in the future. Kimura's two-way distinction of ODA is somewhat similar to what we will propose below.

In what remains, we will present another proposal for reorganizing Japanese ODA which is currently discussed at METI's study group mentioned above.

#### 4. Trade and ODA Policies for Asian Dynamism

##### Inconsistency in external policies

Ideally, various components of external economic policy including trade and ODA are the means to promote national goals concerning how the world economy should be run and what role Japan should play in it. However, despite its huge economic size and the status of largest ODA donor, Japan has not succeeded in establishing clear long-term national objectives in either trade or ODA policy. As a result, two policies are often mutually inconsistent.

For example, Japanese ODA still places much emphasis on industrial promotion in low-income countries, although other development goals such as education and environment are increasingly important. To help industrialization, funds are provided for infrastructure, technical assistance, human resource development and, more recently, policy advice on national development strategy (to Vietnam [JICA-MPI 2001], Laos, Myanmar, etc). In such policy advice, the key issue is how to foster domestic industries under intense integration pressure. Japan feels comfortable with discussing specific industrial promotion measures, since its own industrialization depended much on policy guidelines and coordination. However, certain Japanese ministries oppose this type of intellectual ODA because increasing the competitiveness of developing countries will mean trouble for Japanese industries such as agriculture, food processing, and textile and garment.

Another example is related to Japanese firms investing abroad for survival or

expansion. As these firms begin to re-import their products back to Japan, domestic firms in the same industry lobby for import protection. Conflicts between industrial winners and losers may not be unique to Japan. But it is noteworthy that the Japanese government recently—for the first time—imposed interim safeguards on three items (fresh shiitake mushroom, leek, and tatami mat surface) which are mainly imported from China. This clearly signals shifting official concern from the dynamism of winners to the livelihood of losers. It remains unclear whether this policy shift is consistent with Japan's main challenge today, namely revitalization of Japanese industries.

These are the issues that touch the very root of Japan's external economic policies. They should not be settled in an ad hoc manner by realigning the interests of affected parties alone. Policy changes with such significant repercussions should be designed consistently, guided by a general rule that promotes long-term goals. The level of policy discussion needs to be elevated from domestic interest adjustment to the pursuit of national goals in the context of the world economy.

#### Domestic reforms and external policies are one

The world economy has changed greatly since the beginning of the 1990s. Most important among the changes are IT revolution and asset market inflation (and subsequent deflation) originating from the US, greater international integration, and reorganization of industries driven by these changes. Unfortunately, Japan was not a very active player in them. During the last decade the country was caught in a prolonged recession and associated pessimism permeating through the society. At present, a reform-minded government is attempting to break free from the vicious circle.

Comprehensive supply-side reforms encompassing not just the ailing financial sector but virtually all Japanese industries, seem unavoidable. It must be underscored that structural reforms are closely integrated with external developments such as foreign competition and overseas investment. Supply-side improvements cannot be achieved by domestic measures alone such as deregulation, budget reviews, and administrative reform. It must be complemented by appropriate external policies.

Contact with foreign systems is a very potent catalyst for reform (whether in Japan or CIS). In particular, foreign competition injects a powerful stimulus for change into society. Actual agents of change are Schumpeterian entrepreneurs who respond to foreign challenges by technical innovation or overseas expansion. In fact, many Japanese firms are seeking new values and cost reduction through re-focusing business activities, M&As and business cooperation. This is precisely the dynamic process of shifting comparative advantages. The rise and fall of firms and industries are determined by their performance in global markets, and the government cannot guide industrial restructuring independently from it. Under

globalization, revitalization of the Japanese economy means the re-creation of its industrial status in the context of the changing world economy.

Here lies a big dilemma for Japan, who aspires to domestic reforms but hopes simultaneously to keep or even accelerate protectionism. Domestic reforms and external policies are the two sides of the same coin, and we cannot have the one without the other. If Japan erects a wall against high-value, low-price goods produced by Japanese firms abroad or emerging firms in developing countries, momentum for change will be lost. This is killing entrepreneurship, which is bad for both Japan and the world.

While the weak must be adequately supported through reallocation, retraining and unemployment benefits, help must be provided in a way that preserves their “ownership” for change and economic dynamism. If they are protected without regard for economic rationality and at the cost of consumers and growth industries, the entire economy—including the *protected themselves*—will suffer in the long run. Japan can hardly afford such a policy. An operational guideline to reconcile the needs of winners and losers is seriously needed.

#### Asian dynamism as a guiding principle<sup>7</sup>

As Japan gropes for a new ODA principle, we think such a principle should reflect Japan’s historical position as a non-Western country with a strong manufacturing base as well as an active builder of East Asian production network. While comparative advantage theory and political economy of import protection are certainly useful as analytical tools, they do not quite capture Asia’s unique development experience. In principle, there is no need to confine our vision to Asia, but it is difficult to ignore the existence of a unique development pattern observed in this region and Japan’s heavy contribution as well as reliance on it. Japan’s new ODA principle should be proposed in the context of this Asian dynamism.

Asian economies have a history of dynamic structural shifts through intra-regional trade and investment. Such dynamism was visible even in the 19th century up to the early 20th century,<sup>8</sup> as well as during the 1960s and 70s. This trend accelerated considerably after

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<sup>7</sup> The term *Asian dynamism* was the title of a recent book by Hara [1996]. The book examines not just Asia’s recent manufacturing surge but its ecological diversity and long history of maritime trade as well. We prefer this term to refer to Asia’s development pattern instead of the usual *flying geese* which entail a definitional problem as discussed below.

<sup>8</sup> Collecting and compiling available data, Sugihara [1996] demonstrates that India and Japan were the two countries that stimulated intra-Asian trade from the late 19th to the early 20th century. The rise of Japanese cotton clothes industry and transformation of India from a user to an exporter of raw cotton marked the major shifts in Asia’s trade pattern. Later, China also built its textile industry (partly through Japanese FDI) while Southeast Asia remained absorbers of manufactured goods without becoming their supplier. It is noteworthy that trade with the West continued to be dominant throughout the prewar period, and the sustainability of intra-Asian trade very much depended on it.

the Plaza Agreement of 1985. External economic relations of LDCs are normally dominated by transactions vis-à-vis developed countries, while economic relations among themselves are often very weak. Asia is highly unique in that interaction among developing countries promoted regional industrialization. In this Asian growth, Japan has played a key role not only through its dominant economic size but as a builder of East Asian production network through FDI.

Some argue that the traditional *flying geese pattern* has come to an end as China emerges as a formidable factory of the world [METI 2001]. In their opinion, Asia's growth will be more like acrobatic flying in the future. But the validity of this argument depends on the definition of flying geese. If the flying geese pattern means that Japan must always be the leading bird and NIES, ASEAN and China are the followers in strict order, emergence of China as a first bird (at least for some products) may be a disturbing factor. However, if the flying geese pattern is defined more generally as ordered shifts of industries across countries through trade and investment, it is unlikely to disappear in future Asia; in fact, in some industries such as IT equipment, apparel, etc, the pattern is expected to be further strengthened. In the foreseeable future, Asia will remain the most important overseas production base for Japan. Similarly, through trade, investment and ODA, Japan will continue to be a large provider of development momentum for the rest of East Asia.

We propose that the totality of Japan's external economic policies—trade, investment, aid, finance, exchange rates, labor migration, etc—be rearranged and integrated for the purpose of strengthening this Asian dynamism. Japan as the dominant economy in Asia has the responsibility to sustain this dynamism. Moreover, Japan's own economic and social development depends on it. A new ODA vision consistent with Asian dynamism will contribute to Japan's revival as well as its leadership in the global rule making. On the other hand, if Japan chooses to slow down this dynamism for short-term domestic reasons, such a behavior will surely disappoint its Asian neighbors and may even prompt new "Japan passing" where the source of economic growth is sought without Japan's active participation. If that happens, it will mean the loss of intellectual leadership in external economic policies.

This proposal however should not rule out cooperation with non-Asian regions. Geographical expansion of Asian dynamism (for example, to transition countries in Indochina, South Asia, or Central Asia) should be welcomed.

#### Poverty reduction and industrial promotion

The current ODA charter, issued as cabinet decisions in 1992, requires that environmental concerns, military abuse, democratization and market orientation of the recipient country be considered in providing bilateral ODA. As such, these are noble ideas but too general to serve as a national or regional aid strategy. They may be used as an excuse for



cutting aid to some countries, but they lack concrete contents for solving specific development problems or improving the global economic system. At the operational level also, the aid-executing ministries and agencies (main players are MOFA, MOF, METI; JICA and JBIC) are too preoccupied with daily works and have little time to design a long-term development vision worth presenting to the world. In addition to usual project formulation, a considerable amount of their time is taken up to respond—often passively and belatedly—to domestic political pressure and policy initiatives of the G7, World Bank, and other international organizations.

As discussed earlier, the World Bank is now increasingly targeting their assistance to *poverty reduction* and *Westernization of the development framework*. The former elevates poverty reduction to the sole purpose of development and requires evaluation of all projects in light of this criterion. The latter is an approach in which participation, transparency, accountability, ownership, etc. are emphasized for all countries regardless of development stage or political regime. We think that this framework approach has merits but is insufficient by itself. In view of Japanese and Asian development experiences, the current lack of interest in real-sector problems is extreme and unfortunate.<sup>9</sup> Moreover, we are not convinced that the best way to reduce poverty is to help the poor in sight.

We are not denying the importance of institution-building or poverty alleviation. What we would like to point out is that these general and procedural approaches should be supplemented by concrete real-sector analyses that enable each country to design specific industrial strategies. These strategies should reflect both the unique circumstances of each country as well as unavoidable integration pressure. In low-income developing countries and transition economies with undeveloped markets, coherent official guideline for future industrial structure and promotion policies is essential.<sup>10</sup> For latecomer countries in Asia, development strategy must realistically and concretely address the question of how to participate in the regional production network. Similar long-term real strategies will also be needed even for countries outside the Asian region, with appropriate adjustments as needed.

A keen interest in the manufacturing sector and concrete advice on the way to join

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<sup>9</sup> In Hanoi, Vietnam Development Information Center opened recently to display and sell documents of the World Bank Group as well as other multilateral and bilateral donors. Poverty, environment and human resources sections were relatively well stocked but industry section was initially thin and later abolished as the Center introduced a new shelving system in 2001. Under the current system, most reports produced by Japanese experts in Vietnam will have no place to go.

<sup>10</sup> Discussion of Vietnam's industries by a JICA research project is briefly presented in the appendix, as one example of Japanese interest in real-sector questions. The NEU-JICA joint research is continued this year and a report will be published in 2002. We expect its contents to be radically different from—but not necessarily inconsistent with—those of the World Bank reports. In Vietnam, UNDP/UNIDO is also engaged in policy dialog over specific industries while World Bank studies are more general.

the existing trade and investment systems can be the two main features of our proposed ODA-cum-trade principle. These latecomer perspectives are unlikely to emerge from the West. With this principle, Japan's current assistance portfolio—including human resource development, technical assistance, SME promotion, infrastructure construction, industrial survey, development policy advice, New Miyazawa Plan, etc—can be re-interpreted and justified. It can also expand the area of assistance and cooperation in the future, as well as provide guidance on the question of external dynamism versus domestic interest.

### For Asia and for the world

We propose that Japan's ODA policy should be structured in two pillars. The one is directed toward Asia while the other is more globally oriented.

The first pillar should aim at sustaining and developing the unique growth pattern of East Asia with particular attention to dynamism of regional production networks, meaningful participation of latecomers in it, and formulation of domestic policies consistent with it. For this purpose, ODA policy should be integrated with other external policies including trade, investment, finance, exchange rate, crisis response, labor migration, etc. In other words, ODA should be one instrument among many for pursuing a broader national (and regional) goal. As an external policy, Asian dynamism should be pursued in close consultation with neighboring countries and in an open way which does not exclude countries outside Asia. The boundary of Asia, which receives special attention by Japanese policy makers, should be flexibly and dynamically defined. If advice on non-Asian countries is sought, it should be given indirectly by applying Asian lessons to different regional circumstances.

The second pillar of bilateral ODA should be selective cooperation with multilateral institutions. While promotion of Asian dynamism is important for Japan and Asia, it does not cover the entire areas of economic assistance. For issues touching more or less all countries, such as poverty, environment, education, health and nutrition, private sector development, natural disaster relief, etc, Japan can support and cooperate with relevant international organizations. Such assistance can be given multilaterally through these organizations, but Japan can also contribute bilaterally in the areas where Japan feels it has comparative advantage or additional assistance is warranted. Simultaneously, based on its development vision and national objectives, Japan should shape the policies of these international organizations rather than passively reacting to them.

These two pillars of ODA policy, regional and global, should enable Japan to pursue its own development agenda—real-sector concerns which are unique to each region and country—while continuing to cooperate with the World Bank and other multilateral institutions. In a broader sense, this will enhance Japan's dual identity as a member of Asia as well as the G7 (i.e., the West). This dual identity has caused considerable distress for

Japanese leaders who tried to choose one or the other since the mid 19th century. But we do not think this duality is a problem. Rather, ability to combine two different principles flexibly and to our advantage is a blessing inherited from our history as a late industrializer. With a proper mix of the two, Japan will no longer feel intellectually marginalized despite its large financial contribution. At the same time, the first pillar will force Japan to think strategically about its responsibility in Asia, more consistently and in cooperation with its neighbors.

We do not support the idea that Japan's ODA principle should shadow the World Bank's policy priorities as the Forum for Policy Innovation report (see above) suggests. However useful these policies—poverty reduction and environmental protection—may be, that would hardly be the answer to Japan's missing ODA vision. Suppressing unease with the Bank's approach which many Japanese development officials and economists feel will only increase our distress. We also doubt if economic integration per se should be the primary goal as Kimura [2001] proposes. Fruitful participation in regional dynamism by both developed and developing countries should precede integration as a goal of external economic policies. Too much emphasis on integration may shut out the possibility of even limited and temporary protection by latecomers, which should be allowed in certain circumstances.

## Appendix

### JICA Ishikawa Research Project on Vietnam

#### Trade and Industry Group

##### (Excerpts)

[From 1995 to 2001, Japan International Cooperation Agency (JICA) conducted a large-scale research project offering comprehensive policy advice to Vietnam's Ministry of Planning and Investment. Professor Shigeru Ishikawa was the leader on the Japanese side and the author of the present paper was also heavily involved from the beginning. Over the six years, covered areas included agriculture and rural development, trade and industry, SOE reform and SME development, fiscal and monetary issues, macroeconomic balance, and Asian crisis response. The main features of this project were that (i) this was a joint study by both Vietnamese and Japanese researchers in process and conclusion, not unilateral advice by foreigners; (ii) we presented policy options and respected the government's right to make the final decision; (iii) field studies and surveys were emphasized to collect concrete local facts before theorizing or making proposals; (iv) hasty privatization or trade liberalization were not recommended. The following are excerpts from "Summary of Research and Discussions" of the Trade and Industry Team [JICA-MPI 2001], which show the typical Japanese approach to real-sector problems.]

How to achieve industrialization while promoting trade liberalization is a perennial question for all latecomer countries including Vietnam. Since the dramatic opening of economic relations in the early 1990s, the integration process has proceeded rapidly in Vietnam, leading to large inflows of FDI and ODA, entry into ASEAN and APEC, ongoing negotiations for WTO accession, the Asian crisis and its aftermath, and accelerating competition to attract FDI in East Asia. From the beginning of the Joint Vietnam-Japan Research (JVJR) project in 1995, a majority of Vietnamese policy makers and business leaders have well understood that international integration was essential for systemic renovation and economic development, but that at the same time serious preparations were needed to meet this challenge effectively. In particular, in the past phases of the JVJR project, the Vietnamese and Japanese researchers have emphasized the importance of establishing comprehensive and concrete long-term development strategies for the entire economy as well as for individual key industries.

Up to now, however, the Vietnamese government and business community have not presented sufficiently concrete industrial strategies suitable for the age of integration, nor has identification of candidate industries for promotion (or downsizing) been made. Meanwhile, the AFTA deadline of 2006 is approaching and WTO entry negotiations and the tariffication of NTBs are continuing. Without a clear national industrial vision, consistent designing of industrial promotion and import protection policies, including determination of individual tariff lines, is impossible. The lack of such a vision greatly increases uncertainty associated with the business plans of both domestic and foreign enterprises.

In the third phase of the JVJR project, Trade and Industry Group attempted to

produce studies that could help to overcome this problem. While continuing to investigate general issues related to integration, our main focus in this phase was to intensively examine a very limited number of industries and generate concrete and meaningful policy recommendations. We have chosen (i) steel and (ii) textile and garment for this purpose. Both industries had been studied in the past, but changing circumstances require continuous updating of analysis and advice. Moreover, past studies were often descriptive and superficial, without proposing practical options for solving specific problems that Vietnamese industries were facing.

We did not necessarily agree on key issues nor reach any consensus. Our reports are intermediate outputs in the ongoing and never-ending research and thus should not be construed as final. Despite remaining tasks, however, we feel that certain progress was made in the study of the steel industry, which was scrutinized to the extent that had not been done for other heavy industries in Vietnam. We consider the very process of this cooperative research to be important, apart from whatever tentative conclusions we have reached.

The methodology of steel industry research initiated in this phase can be recommended for similar research on other industries. Above all, the primary emphasis was placed on gathering concrete facts and debating actual problems, rather than general advice or theoretical modeling. We tried to stay away from preconceived conclusions not firmly based on local facts. Fruitful cooperation among specialists of various backgrounds (top managers, foreign businesses, government officials, technical experts, policy analysts, and university professors) enriched our perspective. The Vietnamese side was extremely open with providing facts and discussing plans and problems, and the Japanese side was able to produce preliminary but specific recommendations based on a large number of policy dialogues and factory visits.

In previous research projects by JICA and other donors, foreign researchers often spent much time in gathering basic information (which the Vietnamese experts already knew) and wrote up reports unilaterally without sufficient interaction with the Vietnamese side. At the final presentation, discussion was often too short and the reports did not exactly answer the Vietnamese needs. In this phase, we tried to have substantial discussions between the Vietnamese and Japanese side, as well as among Japanese members, before main conclusions were reached and paper drafts were finalized. The intensive steel seminar in October 2000 was extremely useful in identifying common grounds and remaining disagreements. Some authors significantly revised their papers based on the results of this seminar. Before the main Workshop, drafts and comments were exchanged electronically and papers were later presented in a small pre-Workshop session. Thus, we could devote most of our time at Hanoi Workshop to further discussion rather than paper presentation. The project also played a catalytic role in bringing Vietnamese officials and academics together who would otherwise had much less contacts.

We also relied heavily on the outputs of past and concurrent Japanese ODA programs, including the JICA steel masterplan in 1998 and JICA cold rolling mill feasibility study in 2000. Daily contacts between VSC's top management and a JICA resident expert (Nobuyoshi Tanaka) since 1997 was instrumental in deepening our knowledge and discussion. Moreover, we cooperated closely with experts in the General Commentary Group of the JVJR project (Koichiro Fukui and Takao Aiba) in conducting the intensive steel seminar and producing the reports.

[Steel is a typical import substitution industry likely to face great difficulty when free trade is phased in. However, the Japanese team did not rule out the possibility of steel promotion outright. Instead, we pointed out concrete technical and marketing conditions that must be satisfied before active industrial policy could be launched. These conditions were presented numerically and in detail, after intense scrutiny of both the local steel industry and global steel markets. We believe this is a more effective way to restrain excessive investment than unilateral rejection of promotion. The following are the key points of Japanese recommendations which in original were 14 pages long.]

1. Japanese experts *conditionally* support steel promotion, if realistic and concrete sequencing and methods were adopted.
2. Large-scale integrated steel works should be built gradually and in two tracks.
3. The first hot strip mill should be built in the south (Phu my).
4. Use of domestic ore as a main source was not recommended.
5. Future integrated steel works must be located in the central coastal region.
6. Proven state-of-art technology should be adopted ("fast-second approach").
7. Foreign partners (JVs) must be attracted with realistic investment plans.
8. A large amount of additional investment in Thai Nguyen Iron and Steel Company (TISCO) was undesirable.
9. Special steel production should not be attempted.
10. Ambitious export orientation should not be attempted.
11. Small and temporary deviation from free trade was permissible but only for a few industries with good promotion plans. With WTO, "market access" and "institutional convergence" must be considered on a case-by-case basis. WTO-consistent subsidies and emergency measures might be explored. Unreasonable WTO accession demands must be replaced by fairer treatment.

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