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THE EAST ASIAN MODEL OF ECONOMIC DEVELOPMENT AND DEVELOPING COUNTRIES

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ABSTRACT

This paper examines the debate on the East Asian model of economic development in light of the different approaches undertaken by different groups of countries (economies) in Northeast Asia and Southeast Asia. The common strengths and weaknesses shared by the East Asian countries (economies) have helped to reinforce the misconception that there is a single East Asian model of economic development. There are, however, significant differences in economic structures as well as development experiences among the East Asian economies, especially between the economic development paradigms of Southeast Asia and Northeast Asia. Nonetheless, one single common thread underlies the differences in development strategies and experiences among the East Asian economies—the role of the government. The governments of East Asia have recognized the limitations of markets (or market failures) in the allocation of scarce resources in the economy, and have used government interventions to promote economic development. The recent Asian crisis hardly signifies the end of the so-called East Asian model of economic development.

I. INTRODUCTION

The recent Asian financial crisis has raised a series of questions about the efficacy and sustainability of the so-called East Asian model of economic development. Many have questioned whether the model could be considered valid for other developing countries to follow in pursuit of economic development. In fact, some have suggested that the Asian crisis not only signifies "the end of the Asian miracle," but also signals the failure of the East Asian model.

The debate on the validity of the model is not that simple, however. For instance, South Korea and Taiwan are known to have followed the model for their successful economic development efforts. This model of state-directed capitalism seemed to combine the dynamic aspects of a market-oriented economy with the advantages of centralized government planning and direction. The model has been

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credited for transforming East Asian countries into an export powerhouse and for producing spectacular economic growth. While South Korea, along with other Southeast Asian countries, was hard hit by the crisis of 1997 to 1998, Taiwan has not only avoided the Asian financial contagion, but has also continued to grow at a respectable rate. Is the model itself in crisis or are there other explanations for the varying outcomes of the East Asian model as followed by South Korea, Taiwan, and other Southeast Asian countries? The common economic success as well as the common financial crisis in recent years has led many to presume the existence of a single model of economic development for the economies in East Asia. This is implicit in most of discussions concerning the underlying reasons for the economic rise and fall of East Asia.

The main purpose of this paper is to examine the debate on the East Asian model of economic development in light of the different approaches undertaken by different groups of countries (economies) in Northeast Asia and Southeast Asia. The paper is organized as follows. We first review, in Section II, some of the common elements that are believed to be responsible for the Asian financial crisis, which has opened the debate on the East Asian model for development. Section III examines the old paradigms for development—one emphasizing markets and the other government planning—before discussing the common elements responsible for the rise of the East Asian economies. In Section IV we argue that there is no such thing as a single East Asian model of economic development. Even South Korea and Taiwan, two prime examples of the stylized East Asian model of development, have employed different developmental strategies, resulting in different outcomes. Section V examines some of the similarities as well as differences in development strategies across the economies in Northeast Asia and those in Southeast Asia. The similarities and differences will be noted in terms of the role of government and industrial policy, attitudes, and policies towards FDI and technology transfer, and policies for export-led growth. Section VI concludes the paper with a discussion of the applicability of East Asia's development experiences to other developing countries.

II. EAST ASIA: FROM "MIRACLE" TO CRISIS[1]

Great Reversal of Capital Flows

Outstanding economic performance of the East Asian economies in the late 1980s and the early 1990s attracted a surge in private capital inflows into these emerging economies. That surge in capital inflows helped fuel the increase in the bank credit-financed investment boom. According to the Bank for International Settlements (BIS), the total net private capital flows into the Asian emerging markets during 1994 to 1996 amounted to a whopping $184 billion. In 1996 alone, there was a record capital inflow of $93 billion into Thailand, Malaysia, Indonesia, the Philippines, and Korea (hereafter called the *Asian 5*). But the following year, 1997, saw a net outflow of $12 billion. This amounted to a reversal of $105 billion, equivalent to 11 percent of the combined GDP of the Asian 5. This was the greatest reversal of private capital flows ever recorded in the world economy, and represents "the most significant geo-financial adjustment to date in the relatively new era of globally integrated capital markets" (Makin 1999:408). It was this reversal of capital flows that precipitated the Asian currency crisis, eventually pushing "miracle" economies into a dramatic financial meltdown with serious economic, social, and political consequences.

The East Asian Meltdown: Some Common Elements

The reversal of foreign capital, combined with the flight of domestic funds, caused massive depreciation of the Asian 5's currencies: the Indonesian *rupiah* by 75 percent, the Malaysian *ringgit* and the Philippines *peso* by 40 percent, and the Thai *baht* and Korean *won* by almost 50 percent. These crashes in currency were soon followed by dramatic falls in the stock market in these countries as well as in Hong Kong and Singapore, eventually leading these "miracle economies" into the "Asian meltdown." Government officials, business executives, and academicians pondered what went wrong in East and Southeast Asia. The miracle economies in the region were contracting much faster than anyone had anticipated. Hundreds and thousands of business firms went bankrupt, including some big *chaebols* in Korea. Unemployment soared in a country where lifetime employment was a norm. How could this happen to the miracle economies? Does this mean the end of the East Asian miracle?

The seeds of the 1997 to 1998 Asian financial crisis were sown during the previous decades when East and Southeast Asian countries were experiencing unprecedented economic growth, which has transformed their economies. Although there have been and remain important differences between individual countries, the Asian 5 shared a number of common elements, all contributing directly or indirectly to the crisis. They include a credit-fueled investment boom, a weak and unsound banking sector and financial system, a pegged exchange rate regime, current account deficits, and loss in investor confidence.

Credit-Fueled Investment Boom

During the 1990s, GDP growth in the region exceeded 5 percent per annum and often was closer to 10 percent. Such strong economic growth, and the expectation that the growth would continue, led to an enormous increase in investment. The investment shares in GDP in most Asian countries increased substantially between 1988 and 1996. Between 1990 and 1996, for instance, gross domestic investment grew by over 16 percent per year in Indonesia, 16 percent in Malaysia, 15.3 percent in Thailand, and 7.2 percent in Korea, while investment grew only by 4.1 percent in the U.S. and by .8 percent in all other high-income countries (World Bank

1997, table 11). Much of this unprecedented growth in investment in these Asian countries was financed by bank credit, and was concentrated either in areas with highly volatile returns, such as stocks and real estate, or in areas where substantial capacity already existed, thus leading to over-expansion and excess capacity.

Inefficient Bank-Centered Financial Systems

One of the elements shared by the Asian 5 has been the weakness of their bank-centered financial systems. The banks in these countries simply failed to develop appropriate procedures for evaluating risks when extending loans. There was little incentive to develop such procedures because the bank managers were subject to direction by the government authorities, and they expected the government to support their borrowers. The government-directed, discretionary policy of credit allocation for rapid economic growth may have achieved its goal, but the financial institutions, including commercial banks, became simply a "silent partner" in the process of economic development. Financial repression, characteristic of the East Asian model for development, has been responsible for the unsound, weak, and inefficient financial systems in these countries. The surveillance of bank operations was lacking, and prudent regulation of the banking system was lax, resulting in inadequate bank capital relative to the risky bank loans. In addition, banks did not have adequate capacity for project evaluation in lending practices, especially in the aftermath of increased financial liberalization in these countries. As a result, when economic conditions abruptly worsened, the quality of the bank assets deteriorated quickly, producing non-performing loans.

Exchange Rate Misalignment

Mainly as a way of inducing foreign capital, all of the Asian 5 currencies had, in one way or another, been aligned with or pegged to the U.S. dollar or a basket of currencies dominated by the U.S. dollar. This linking of the official exchange rates to the U.S. dollar had one major drawback. As the value of the dollar changed, so did the exchange value of these currencies relative to other currencies that are not tied to the dollar such as the Japanese *yen* and the German *mark*.

The impact of the exchange rate misalignment can be traced back to the Plaza Accord of 1985. As the Japanese *yen* began its rapid appreciation against other currencies, particularly the U.S. dollar, the relative costs of production rose in Japan. In response, Japanese firms shifted their production activities overseas, mainly to Korea and Taiwan. To counteract the blow of this outward FDI to the domestic economy, the Japanese government used aggressive monetary expansion. This created giant asset bubbles in Japan and massive capital outflows into Korea and Taiwan. By the late 1980s, these two countries came under similar pressures as a result of the appreciation of the Korean *won* and the Taiwanese *dollar*. To combat these pressures so as to maintain the exchange value of their currencies in terms of the U.S. dollar, they relied on aggressive monetary expansion. The results were asset price bubbles at home and large capital outflows, this time primarily to Southeast Asian countries such as Thailand and Indonesia.

The seeds of the financial turmoil were sown in the mid-1990s when the U.S. dollar started to appreciate against other currencies, especially the Japanese *yen*. The Asian currencies tied to the dollar rose in value and made their exports more expensive to non-dollar buyers and their imports from non-dollar areas cheaper. The weakening *yen* drastically reduced the export competitiveness of the Asian 5 vis-à-vis that of Japan. The result was to increase the current account deficits for the Asian 5. Downward pressures created by the increased current account deficits necessitated increased government intervention to maintain the exchange value of their currencies, depleting their foreign exchange reserves; all of this, in addition to the adverse impact of the devaluation of the Chinese *renminbi yuan* in 1994.

Coincidence and Compounding

Considered separately, none of the elements that are usually put forward as contributing factors are enough to explain the source and extent of the Asian crisis. The interaction of these elements produced a conjuncture of problems, compounding the vulnerability of these economies to external shocks. Thus, Grenville (1998:13) sums up the story of the Asian meltdown:

> Large capital inflows led, more-or-less inevitably, to excessive credit growth and growth of the financial sector, because it was not possible to sterilise them fully. The large flows meant, also, that there was easy funding available for projects (both good and bad), and that asset prices were bid up. Similarly, the large capital flows made it difficult to raise interest rates higher (they were already quite high), for fear of inducing even more capital inflow. High domestic interest rates, at the same time, persuaded many borrowers to take the risk of tapping into attractively lower foreign currency-denominated borrowing. Further, with quasi-fixed exchange rate regimes in these countries, there was little incentive for institutions borrowing in foreign currencies to hedge their debt. These issues should have been recognised as sources of vulnerability, but the focus was on growth, without enough concern about resilience in the face of *variance* in growth.

The crucial combination was the large, volatile, foreign capital flows and the fragile financial systems. These two elements, in combination, made the Asian emerging market economies extremely vulnerable to changes in investor *confidence.* Financial markets are supposed to constantly digest and evaluate information to produce a price, an exchange rate, which reflects the "fundamentals." In the Asian emerging markets, however, "the more nebulous concept of 'confidence' dominated fundamentals" (Grenville 1998:13). Thus, leading Jeffrey Sachs

(1998) of the Harvard Institute for Development to lament, "In a matter of just a few months, the Asian economies went from being the darlings of the investment community to being virtual pariahs. There was a touch of the absurd in the unfolding drama, as international money managers harshly castigated the very same Asian governments they were praising just months before… But, as often happens in financial markets, euphoria turned to panic without missing a beat. Suddenly, Asia's leaders could do no right. The money fled."

III. Alternative Approaches to Economic Development[2]

Market vs. Central Planning

Before the rise of East Asia, two paradigms dominated development economics literature: one focused on markets guided by Adam Smith's "invisible hand" as an effective mechanism to promote economic growth, and the other on government planning to ensure resources are mobilized and deployed in ways that promote economic growth. The empirical tests of these opposing paradigms were to be provided by the outcomes of the "developmental race" initiated in the 1950s between India and China.

China and India, the two giants of Asia, entered the post-WW II era, sharing the world's greatest development problems. Both represented the classic problem of an "underdeveloped area" with a huge population relative to land and other resources; a predominantly agrarian society with masses of populations living in extreme poverty. In 1950, the new governments of China and India led by Mao Zedong and Jawaharal Nehru made explicit commitments to national planning for economic modernization, to eradicate poverty and raise the standard of living for the masses.

In their drive for economic development and modernization, both countries turned away from open-door strategies aimed at integrating their economies into the world economy. The most important characteristics shared by both countries, namely, the abundance of people relative to other scarce resources such as arable land, natural resources, and capital, suggested that the appropriate strategies for development would have involved production of labor-intensive goods, some of which would be exchanged for imports of capital goods and technology necessary for development. However, both countries turned away from export-oriented, outward-looking strategies, and from integration into the world economy.

Both China and India were opened up to the outside world by the force of Western arms. Xenophobia and a suspicion of foreigners continued to remain endemic in both countries even after their independence. Both China and India turned toward autarky, and found the Soviet model of central planning resonant. The resulting development strategy was import-substituting industrialization based on the promotion of heavy industries. Both followed autarkic trade policies with a barrage of trade and exchange controls, which effectively cut off any link between domestic and international markets. They also systematically discriminated against agriculture by taxing it directly or indirectly in order to finance industrialization.

For China, the Soviet model of development and advice for its application were at hand when the Chinese Communist Party took power in 1949. Mao Zedong did not have a settled national economic policy for reconstruction and development. The outward-looking, market-oriented alternatives were simply pushed beyond reach because of China's engagement in the Korean War in 1950 and the ensuing Cold War between the two major powers, the Soviet Union and the United States (Garnaut 1996). In India, a national planning commission established a comprehensive 5-year program to begin in 1951, "a plan that rapidly acquired international status as an empirical model of accepted development theory" (Malenbaum 1982:46). The plan stipulated the new levels and channels for national consumption, savings, and investment, and outlined new policies to achieve these goals. Unlike the central planning under the Communistic Soviet Union and China, India's economic planning was to be carried out under a parliamentary democracy to assure individual freedoms and to retain the market system for economic decision-making. In China, however, development policies and plans were to be carried out by the centralized government controls of a Soviet-type system. Under Mao Zedong, private ownership and control were replaced by the centralized, authoritarian decision making of public authorities. By the time China's first 5-year development plan was implemented in 1952, nationalization and land reform were already "blending into effective tools for resource mobilization and allocation" (Malenbaum 1982).

Thus, the early 1950s saw the beginning of "the developmental race" between the two giants of Asia who shared similar development problems. Both were similar in their size, historical background, and in their economic structure and status (that is, extreme poverty among the masses of populations); also similar were their national goals and aspirations for raising living standards for the masses of population through economic modernization and development. Both countries were vastly different, however, in their ideologies: Communism in China and British Fabian socialism in India; in their governmental institutions: a totalitarian regime in China and a parliamentary democracy in India; and in their approaches to implementing developmental policies and plans: a command system of centralized controls in China and the market system with "planning" in social democratic thinking in India.

The race elicited wide interest on the part of government officials, scholars, and citizens everywhere. To many in the West, India's economy was viewed as "a democratic experiment in development and hence perceived as an alternative to China's totalitarian path" (Bhagwati 1993: 6). The outcome of the race would have some far reaching political implications: If China won, the totalitarian model of the Soviet Union and its ally China would have a profound impact on the leadership of Third World developing countries, pushing them further into the

Soviet bloc. Many, however, expected that India would emerge as the winner of the race.[3]

Economic Performance

During the 1950s and 1960s, both economies seemed to perform well in mobilizing domestic resources for economic development. The "big push" argument for development[4] seemed to be working in reality, and their achievements demonstrated that it was possible to raise per capita income and living standards even in these populous countries. Although a comparison of the relative economic performance of India and China had been hampered by statistical problems of estimating China's national output and population, many researchers agreed that until the 1970s China grew faster than India.

Central planning and bureaucratic regulation and protection may boost economic growth *rapidly* in the early stages of development. They may be effective in mobilizing resources and channeling investment into new activities that are artificially selected, protected, and promoted. However, bureaucratic regulation on economic performance impact social and political processes that emerge *gradually* over time. For instance, controls will breed rent-seeking activities, stifling efficiency in resource allocation, production, competition, and economic growth in the long run.

The East Asian Miracle: Some Common Elements

By the 1970s, it had become clear that the winner of "the developmental race" would be neither India nor China. The race ended altogether with different dark horses when the (uninvited) four East Asian NIEs—South Korea, Taiwan, Hong Kong, and Singapore—crossed the finish line first in the middle of the race in the early 1980s. The broad interest in the race between the two giants of Asia was soon lost, and the developmental strategies of these East Asian tigers soon became the focus of universal attention. The economic achievements of the East Asian NIEs are truly extraordinary and historic, and their success has been aptly referred to as "the East Asian miracle." This miraculous economic success was initiated by Japan, which grew by 9 to 10 percent per year from the mid-1950s to the early 1970s. Following the footsteps of Japan, the four East Asian tigers started to grow rapidly in the late 1970s. Export-oriented development strategies guided by the government are believed to have provided the conditions for successful "takeoff" as suggested by Rostow (1960), especially in the case of Korea and Taiwan. Right behind these four tigers were Malaysia, Thailand, and Indonesia, which started to grow rapidly in the mid-1980s, and they were soon followed by China. These countries have shown double-digit growth rates in the 1990s. Some writers, like Krugman, have contended that there is nothing "miraculous" about the East Asian miracle,[5] thereby opening up the total factor productivity debate. Nonetheless, hardly anyone contests the remarkable economic success of the four little tigers of East Asia, who won "the developmental race" of the twentieth century, and the second-tier NIEs of Southeast Asia.

The success of the East Asian economies and the collapse of the socialist economies called into question the standard paradigms for development and their intellectual foundations (Stiglitz 1996). The East Asian success story has raised many important questions in development economics in theory as well as policy: Why did some countries grow so rapidly, as much as 8 percent per year or more continuously for more than two decades, while others (notably in South Asia, Latin America, and Africa) failed? What did these East Asian countries (or economies) do right? What are the common threads that led these economies to successful takeoff? Can these successful development experiences be replicated in other developing countries?

Despite numerous differences in history, culture, and economic and political institutions in most of the East Asian countries (economies) that are part of the "East Asian miracle," one factor stands out: That is, "government undertook major responsibility for the promotion of economic growth" in these countries (Stiglitz 1996:151). In addition, some of the common ingredients of economic success are as follows: (1) These countries (economies) have all pursued export-oriented development strategies; (2) They have been successful in maintaining high rates of saving and investment; (3) Emphasis has been placed on promoting universal education and making enormous investments in human capital so as to better absorb and adapt the most advanced technology; (4) For almost all of the East Asian economies, with the exception of Hong Kong, industrial policies were an important part of their growth strategies.

IV. The East Asian Model of Economic Development

A Single East Asian Experience or Model?

Because of the common ingredients of the East Asian miracle and the common structural weaknesses shared by these economies that are believed to have contributed directly or indirectly to the East Asian crisis (as discussed previously in Section II), a misconception has been created that there is a single East Asian model of economic development. There is no such thing as a homogeneous East Asian model of economic development or experience, however. Among the East Asian countries, at least five categories of industrialization experience can easily be identified: (1) The Japanese case of government-directed industrialization; (2) South Korea and Taiwan, following closely the footsteps of Japan, with state-directed production and exports for the world market; (3) Two city-states of Singapore and Hong Kong (now reverted back to China) with completely open "free ports" to the outside world; (4) The second-tier NICs of Malaysia, Thailand, and Indonesia with FDI-led exports and growth; (5) China, since 1978 and the leadership of Deng Xiao-ping, with its open-door policy for FDI and substantial public expenditures on infrastructure development.

To be sure, there is no established and agreed upon definition of the East Asian model of economic development.[6] Compared to its Western counterpart, however, the model as used by Japan, and later by South Korea and Taiwan, has several distinguishing features. The most important one is that governments play an important, proactive role in the process of industrialization and economic development. Both South Korea and Taiwan can be characterized as what Chalmers Johnson (1987) called the "developmental state," in which the state recognizes economic development as the primary goal and does not hesitate to intervene in a market-oriented economy to achieve this goal. As a capitalist state, the developmental state is committed to private property and the market system. The government bureaucrats who formulate and implement strategic industrial policies to promote economic development, however, closely monitor the workings of the market system. Both South Korea and Taiwan also promoted a bank-based financial system under close government control. They also used international trade as the primary means for economic growth and development. Among other things, these commonalities shared by both South Korea and Taiwan help explain the phenomenal economic success achieved in the past three decades.

Different Strategies for Development: South Korea and Taiwan

Although South Korea and Taiwan are the prime examples of the stylized East Asian model of development, the approaches taken by these two countries in their application of the model were different: a "big is beautiful" type of approach in Korea, and a "small is beautiful" type of approach in Taiwan. In South Korea, economic policy was geared at achieving rapid economic growth whereas macroeconomic stability was given higher priority in Taiwan. Big business conglomerates, known as the *chaebol*, emerged as the engine of growth dominating the South Korean economy, while in Taiwan small and medium-sized enterprises (SMEs) played a central role in economic growth and development. The different outcomes of the 1997-98 crisis for South Korea and Taiwan may be attributable to these differences in policies and approaches adopted by the two in their application of the East Asian model of development.[7]

In South Korea, the growth-first policy involved selecting some specific sectors or business firms to nurture through the government-directed, discretionary policy of credit allocation and other measures. The financial institutions were placed under government control, and they became simply a "silent partner" in the process of economic development. In this process of credit allocation, SMEs (small and medium sized enterprises) were given little or no consideration for government support. In Taiwan, on the other hand, emphasis was placed on nurturing the spirit of individual entrepreneurship for SMEs. It is these SMEs who laid a firm foundation for the sound financial system and industrial organization in the

Taiwanese economy. In the case of South Korea, there is little doubt that the growth-first strategy with "financial repression" under the government-controlled financial system and the selection of prioritized industries to be developed achieved the goal of rapid economic growth. But unfortunately, the strategy also helped to create giant industrial conglomerates, the *chaebol*, which by the end of the 1970s had already become "too big to fail," and dominated the South Korean economy. In the 1980s and 1990s, the state deviated from its status as a developmental state, and the *chaebol* became too big and powerful to control, eventually pressuring the government to prematurely deregulate and liberalize financial markets. This greatly reduced the government's ability to control and regulate international short-term capital flows, known as "hot money." The government, rather than directing and guiding business firms towards its developmental goals, began to resemble an agent of the *chaebol* (P.H. Park 2000).

As in South Korea, Taiwan also followed the stylized East Asian model of development, but emphasis was placed on economic growth with stability. Accordingly, the Kuomintang (KMT) regime implemented economic policies aimed at preventing inflation, financial instability and the concentration of private capital. To maintain monetary stability, the government nationalized the banking system and placed the entire financial sector under its control. As a result of this tight regulation and control of the financial sector and the policy of avoiding excessive concentration of private capital, Taiwanese firms had to rely on their own funds, small loans from a number of banks, and money borrowed from relatives and friends. This reliance on traditional household networks for financing has been largely responsible for shaping the Taiwanese industrial structure: First, it has limited the size of business firms because there were no huge concessionary or special loans such as those made available under the growth-first strategy in South Korea. Second, the debt-equity ratios for Taiwanese firms tended to be much lower than those of the South Korean counterparts since banks were not willing to lend large sums to individual firms, and they could only borrow so much from the traditional household networks.

Taiwan's anti-inflationary policy, along with a high-interest-rate policy, was successful in boosting capital accumulation and growth. Unlike South Korea, Taiwan did not have to depend heavily on foreign borrowing to finance domestic investment. In fact, during the period 1971-1994, Taiwan was able to finance its entire gross domestic capital formation out of internally generated domestic savings (P.H. Park 2000:160, table 7.6). This, of course, greatly reduced its vulnerability to foreign debts and external shocks. While South Korea relied heavily on foreign borrowing and blocked foreign direct investment (FDI), Taiwan opened its door to FDI. Inward FDI into Taiwan not only contributed to capital formation, but also served as an important vehicle for technology transfer (Chowdhury and Islam 1997).

V. East Asia's Varying Development Strategies and Experiences

There are studies that recognize significant differences among the East Asian economies. The World Bank's miracle study (World Bank 1993), for instance, proposes at least two types of models of East Asian development, one based on the Japanese paradigm of industrial policy and more active state intervention as followed closely by both Korea and Taiwan, and the other on the more open and market-friendly regimes of Southeast Asia. Similarly, another study by Terry (1996) stresses the dichotomy between the development experiences of Northeast Asia and Southeast Asia. Recognizing the dichotomies acknowledged by these studies, we examine some of the differences in development strategies chosen by the East Asian economies. Where possible, we will try to discern some similarities across the economies in Northeast Asia and those in Southeast Asia. In particular, the similarities and differences will be noted in the following aspects in the process of industrialization: (1) the role of government in general; (2) industrial policy in particular; (3) attitudes and policies towards FDI and technology transfer; and (4) incentives and policies for export-led growth.

The Role of Government

Some argue that the Asian crisis has demonstrated a limited life for the interventionist model for economic development. The model worked out successfully for Japan and East Asian countries, including South Korea and Taiwan, while the following conditions prevailed: First, countries must have a high household savings rate; there must be a political consensus that the benefits of financial repression (favored firms receiving low-cost loans) exceed the costs to consumers or those investors who must use informal or curb capital market; there must be rapid increases in GDP, both to build political support for the intervention and to mask its inefficiencies; countries must run trade surpluses in order to build foreign exchange reserves; and finally, countries should be in the early stages of economic expansion, when capital accumulation matters more to growth than technological progress. Once economic growth begins to slow down because of accumulating inefficiencies and a diminishing marginal product for capital, the inefficiencies would become harder to hide, investor optimism would begin to fall, and political support would erode. The interventionist model for development of the East Asian type carries with it the seeds of its own destruction, and world integration makes it less viable in the long run (Cargill and Parker 1999).

However, one must keep in mind that a premature relaxation of intervention by the state may bring a disaster. One important contributing factor to the Asian crisis is not "too much of state intervention" but rather "lack of it." As in Korea, for instance, "the crisis stemmed from the uncontrolled debt-financed expansion of the *chaebols*. The government's abdication, in the face of *chaebol* power, of activist state coordination of private-sector investment and its relaxation of controls over the private sector's foreign borrowing were the key factors that precipitated the crisis" (Bello 1999). In several of the Asian crisis countries, badly managed financial liberalization lifted restrictions on bank borrowing and lending before putting in place a sound regulatory framework. Many of the problems arose not because governments did too much, but because they did too little, and because "they themselves had deviated from the policies that had proved so successful over preceding decades" (Stiglitz 1998). In South Korea, as the *chaebol* became too big to fail and their power increased, the state's power eroded and, unfortunately in the 1980s and 1990s, the state "evolved in such a way that it came to resemble a racketeering state rather than a developmental one" (P.H. Park 2000:62). In Taiwan, however, unlike in the case of South Korea, the government never lost its autonomy even after significant measures of liberalization were introduced in the financial and industrial sectors. The state was able to remain a developmental state, still occupying the "commanding heights" in the Taiwanese economy.

At least two lessons can be drawn from the South Korean and Taiwanese experiences with economic development. One, economic stability cannot be sacrificed for rapid economic growth. Two, a strong government with an economic bureaucracy that is highly capable but still independent of the business community is an essential institutional prerequisite for successful policy formulation and implementation (Evans 1998). For instance, the Taiwanese government never lost its autonomy, and remained a developmental state, maintaining its "commanding heights" in the economy. This is in contrast to South Korea where the powerful *chaebol* wielded a strong influence over government policy; Taiwanese firms were not allowed to consolidate their economic power, and they were constrained to conduct their financial and industrial operations in a highly flexible, widely diversified manner. It was these small-scale, flexible, and informal household network groups in Taiwan that became highly instrumental in easing the adaptation of the economy to changing circumstances and external shocks (Wang 1998).

Industrial Policy

Compared to static comparative advantage, dynamic comparative advantage refers to the creation of comparative advantage through the mobilization of skilled labor, technology, and capital. Either the private or public sector of the economy can create such an advantage. When governments attempt to create comparative advantage, the term industrial policy is used. Industrial policy thus seeks to encourage the development of emerging, sunrise industries through various government measures such as tax incentives, R&D subsidies, credit allocation, and protection against foreign imports. It is an attempt by the government to influence the industrial structure of the economy and the allocation of resources between different industries. Simply put, industrial policy refers to government actively intervening in the economy and selecting some specific industries to protect and nurture.

Almost all of the economies in East Asia had industrial policies, suggesting that such policies were an integral part of their development strategies. However, it is known that the governments of Japan, Korea, and Taiwan pursued more active industrial policies than their Southeast Asian counterparts. In other words, the Southeast Asian economies relied more on market forces in determining winners and losers among industries.

The early Japanese industrial policy was targeted at those industries with income-elastic demands in the international market and with substantial large-scale economies. The industries selected for nurturing included steel, automobile, textiles, shipbuilding, and, in later years, the electronics and semiconductor industries. The government directed credit towards large business firms in these industries, and domestic markets for these industries were heavily protected against foreign competition to help firms realize large-scale economies.[8] As in Japan, the government of Korea also used credit allocation and protection from foreign imports to nurture targeted industries. Unlike in Japan, however, the Korean government promoted specific individual business firms more actively to cope with perceived deficiencies in entrepreneurial role and skill. These policies were directly responsible for creating large business conglomerates, known as *chaebol*, which dominated the Korean economy. The big losers were, of course, SMEs.[9]

In 1969, the government of Malaysia formulated the New Economic Policy (NEP), which was designed to redistribute the wealth and economic activities from non-Malays to Malays. As part of this NEP, the government targeted heavy industries mainly because the Chinese dominated the light industries. A state-owned holding company, called Heavy Industries Corporation of Malaysia (HICOM) was established to manage various projects in heavy industries through joint ventures with foreign partners. HICOM projects included the Proton Saga (the national car), an M$1.2 billion iron and steel plant, and a number of energy-refining and utility projects (Brown 1994). The anticipated economic "takeoff" based on state-led, "big-push" industrialization efforts did not materialize simply because both internal and external economic conditions were not favorable. Almost all units under HICOM went into the red. As a result, the management of state industries was turned over to private sector managers in 1988, who were mostly non-Malays. This (courageous) change in management signaled a change in government industrial policy—away from the earlier efforts at state-led industrialization toward more emphasis on market signals and the profit criteria for evaluating state enterprise performance, and at the same time privatization and denationalization of industries have gained momentum in Malaysia (Bowie 1994).

As in Malaysia, Indonesia also made serious attempts at state-led industrialization. In particular, efforts were made to emulate Korea's *chaebol*-led development of heavy industries. A group of bureaucrats known as "technologists," who pushed for large-scale, high-tech investment projects, became influential.

Indonesia's industrial policy, however, has not been successful mainly because the state's capacity for effective intervention was hampered by bureaucratic weakness and incapability. Consequently, "selective intervention on Korean lines could not work in countries like Indonesia because of weaker administrative and institutional structures, less clear economic objectives and skill limitation" (World Bank 1993:170).

Industrial policies as used by the East Asian economies have been widely criticized on several grounds. One serious charge is that even though there is a rationale for government intervention (presence of market failures), government simply does not do a good job in picking winners, that is, industrial policy is distortionary. According to Joseph Stiglitz (1996), such criticism is either exaggerated or misguided: Good decision-making by the government necessarily involves making mistakes; the government was not heavy-handed; virtually all governments in East Asia decided to support export-oriented industries, which was essentially choosing a winning development strategy, rather than simply picking winners in the narrow sense of the term. Most important of all, through their industrial policies, East Asian governments have performed an entrepreneurial role: "Entrepreneurship requires combining technological and marketing knowledge, a vision of the future, a willingness to take risks, and an ability to raise capital. In early stages of development, these ingredients are typically in short supply. The governments in East Asia stepped in to fill the gap—but in a way that promoted rather than thwarted the development of private entrepreneurship" (Stiglitz 1996:162).

Policies towards FDI and Technology Transfer

FDI has not been a significant factor in Japan, Korea, and Taiwan, although it played a much larger role in Hong Kong and particularly in Singapore. For all second-tier NIEs of ASEAN, however, FDI has been much more important than for countries in Northeast Asia.

In both Japan and Korea, the governments adopted policies to restrict foreign ownership by imposing ceilings for foreign ownership in specific industries and by providing various fiscal incentives for joint ventures rather than full foreign ownership. Such restrictive policies grew out of their concern about control of domestic industries by foreigners, which may pose difficulties in implementing development strategies, and their concern about developing indigenous firms. At the same time, however, the transfer and adaptation of foreign technology was recognized as a critical link in the process of industrial development. While restricting both FDI and foreign ownership, the Korean government emphasized the promotion of absorptive capacity and indigenization of foreign technology through reverse engineering. Formal R&D was not that important when imitative reverse engineering was successfully carried out. Korean firms were able to assimilate import-embodied technology so rapidly that they were able to undertake subsequent expansion in production, and upgrade the industrial structure as well (Ahn 2001).

Compared to the Northeast Asian countries, the Southeast Asian countries, in general, have been more open and receptive to FDI and other foreign capital. Singapore had few restrictions and regulations governing FDI and MNCs. In fact, one of the major tasks of the Economic Development Board (EDB), a Singaporean government agency, was to scout for foreign investors. Malaysia, adopting the "Look East" policy in 1981 to emulate the industrial deepening efforts of Japan, Korea, and Taiwan, also actively sought FDI, especially from Japan. FDI has played a central role in the emergence and success of export-oriented manufacturing sectors in Malaysia, especially in electronics (Athkorala and Menon 1995). Traditionally, Thailand has maintained a liberal attitude towards FDI. The promotion of FDI has been a major element in every national development plan since 1960. As in Malaysia, the government of Thailand has placed the highest priority on FDI-led, export-oriented industrial development. FDI from Japan has played a significant role in developing and upgrading the automobile and electronics sectors of the Thai economy (Yoshida 1992).

Incentives and Policies for Export-Led Growth

Despite substantial differences in factor endowments and initial economic conditions, virtually all of the East Asian countries have pursued export-oriented policies for their industrial development. In terms of the old idea of economic takeoff (Rostow 1960), export growth in these countries provided fuel for takeoff for industrialization. This export-led industrialization was led by Japan, and followed by other groups of East Asian countries one after another, like a group of geese flying in V-formation. This metaphor for economic development has been known as the "flying geese" hypothesis (Akamatsu 1961), popular among academicians in Asia, particularly in Japan.[10]

Difference in resource endowments played a key role in determining when and how the East Asian economies shifted from import substitution to export promotion in their development strategies. For the economies of Northeast Asia, the paucity of natural resources was an important factor responsible for their rapid shift to manufactured exports, which required industrial upgrading through more active and selective industrial policies by their governments. In contrast, for the Southeast Asian countries like Malaysia, Thailand, and Indonesia, the rich natural resource base gave rise to agro-based leading sectors for economic development, "which could become competitive on world markets with a more modest initial role for the government and less dependence on imported inputs" (Akyuz, Chang, and Kozul-Wright 1998:18). Because of rich natural resource endowments, these countries were able to pursue industrialization based on import substitution for a longer period than the countries of Northeast Asia, but limits on the growth potential through import substitution became apparent in the 1970s and early 1980s.

In their policy reforms involving a switch towards export-oriented industrial development, these Southeast Asian countries were willing to allow FDI to play a key role in compensating for "the absence of local entrepreneurial and organizational skills, capital, technological capacity and international marketing networks" (Akyuz et al. 1998:20). As mentioned earlier, the "Look East" policy was undertaken in Malaysia to emulate the industrial upgrading policies of Japan, Korea, and Taiwan. More liberal foreign investment laws were introduced, and their implementation accelerated in the 1980s. The timing of this shift in policy coincided with a sharp shift in the competitive position of business firms of Japan and the first-tier NIEs of Northeast Asia, thereby allowing the second-tier NIEs to take over comparative advantage in such manufactured exports as electronics.

As in the economies of Northeast Asia, however, labor-intensive, export-oriented manufacturing industries in Southeast Asia did not develop spontaneously through the availability of cheap labor and greater reliance on freer trade and FDI for the transfer of technology and managerial skills. In addition to the provision of infrastructure and universal education, various government measures have been used to accelerate investment in these industries. These measures include subsidies, tax breaks, support for training programs, and various export promotion measures, which are simply part of an industrial policy to create dynamic comparative advantages.

VI. Concluding Remarks

The East Asian economies were similar in many respects: high rates of savings and investment, export-led industrialization, macroeconomic stability, investment in physical and human capital, and willingness to absorb foreign technology. These shared characteristics enabled their miraculous economic success. At the same time, they also shared a number of structural weaknesses in their economies, including weak and inefficient financial systems, lack of corporate transparency and accountability, close relationships between government and business, and widespread corruption. Such common weaknesses are believed to have played a role in precipitating the Asian financial crisis.

These common strengths and weaknesses helped to reinforce the misconception that there is a single East Asian model of economic development. There are, however, significant differences in economic structures and the development experiences among the East Asian economies, especially between the economic development paradigms of Southeast Asia and Northeast Asia. Even for the two prime examples of the stylized East Asian model such as South Korea and Taiwan, development strategies and experiences were vastly different. A deeper and well-balanced understanding of East Asia's economic success and its "downfall" requires a better understanding of the differences and the similarities as well. The structural differences and differences in development paths among the economies of Northeast Asia and Southeast Asia suggest that it is altogether inappropriate to presume the existence of a single East Asian model of economic development.

There is, however, one single common thread underlying the differences with development strategy and experience among the East Asian economies: the role of the government. The governments of East Asia "undertook major responsibility for the promotion of economic growth," they recognized the limitations of markets (or market failures) in the allocation of scarce resources in the economy, and used government interventions to promote economic development. Government interventions were used to pick winners in the manufacturing sector, to promote cooperation and competition among firms, and to lead export-led industrialization. Rather than replacing markets, "these governments promoted and used them" (Stiglitz 1996: 156).

Among a large number of causes of the Asian financial crisis discussed in the literature, there is one influence that is often overlooked: rapidly increasing globalization of business activities and markets in the world economy. The East Asian countries (and all other countries as well) have been simply too slow to fully appreciate the new challenges and risks posed by the rapidly globalizing financial markets. Consequently, they have been too slow in formulating appropriate responses and policies. Globalization has increased the speed and magnitude of market reactions. It has magnified the costs of bad, inconsistent policies and weak, inefficient institutions. In today's global environment, the forces of globalization are simply beyond one's control. In short, Pacific Asian countries have simply fell victim to globalization.[11]

Globalization, if properly managed, may help push some developing countries into modernity and affluence. But as the Asian financial crisis suggests, embracing global financial markets can also be highly dangerous and costly. The Asian crisis has shown how important it is to have effective state institutions that are capable of successfully mediating the impact of globalization on economic development. Therefore, "heightened exposure to world markets will only become a true lever of economic development in the presence of institutions able to mitigate market failures and manage the competitive challenges and domestic dislocations produced by openness" (Heredia 1997:384). Exceedingly drastic measures of liberalization and opening up may weaken the existing relation-based governance structure of the economy before a new and more rule-based governance mechanism could function. Korea and Thailand may be a case in point. In the early 1990s, financial liberalization as well as political liberalization in these countries proceeded, perhaps too fast and too early, before an effective rule-based governance structure was put in place. In short, "the dismantling of too many existing relation-based mechanisms in so short a period can damage the future potential of economies at an early stage of development to continue to catch up" (Li 1999:28).

The recent Asian crisis hardly signifies the end of the East Asian model of economic development. For many Third World developing countries, the relation-based East Asian model of economic development, if properly adopted and executed, as in the case of Taiwan, can be effective in facilitating a "catching-up" in the early stage of economic growth and development. In the wake of the Asian crisis, the credence of the model has been seriously questioned, but the model itself is not in crisis. It is the strategy or approach to be used in its application that must be carefully weighted and evaluated for individual countries.

NOTES

1 Unless otherwise specified, East Asia is broadly defined in this paper to include the whole region of both Northeast Asia and Southeast Asia, including (1) Japan, (2) the first-tier NIEs of South Korea, Taiwan, Hong Kong and Singapore, (3) the second-tier NIEs of Malyasia, Thailand, Indonesia, the Philippines and other emerging markets of ASEAN, and (4) China. This section draws heavily on: J.H. Park (2002b).

2 Discussion in this section draws heavily on: J.H. Park (2002a).

3 In fact, the early writings of the leading development economists such as Walter Rostow, Max Milliken, Paul Rosenstein-Rodan, Wilfred Malenbaum, and George Rosen, were all optimistic and well disposed toward India's economic planning and methods.

4 According to the doctrine of the "big push," a government should put in place all the measures for development at the same time, such as mobilizing domestic resources and channeling those resources into large-scale physical investments in infrastructure, basic industry, and research and development; developing legal and institutional changes, etc.

5 See Krugman (1994). For a rebuttal, see Radelet and Sachs (1997). Also, for a succinct summary of why we continue to have ample grounds to view the East Asian growth as "miraculous," see Barro (1998).

6 See, for instance, Adams and James (1999); Akyuz (1999); and Berger (1988).

7 For an excellent comparative study of the South Korean and Taiwanese experiences of economic development, see: P.H. Park (2000).

8 For a comprehensive review of the Japanese experience with industrial policy, see Woronoff (1982) and Johnson (1982).

9 For more comprehensive discussions of the Korean experience with industrial

policy, see Leipziger (1993) and Amsden (1989).

10 Japan, flying in front, is flanked by Hong Kong and Singapore and followed by South Korea and Taiwan. Behind South Korea and Taiwan are Malaysia and Thailand and then Indonesia and the Philippines. The order of these East Asian countries (economies) reflects each economy's stage of industrialization and level of per capita income. In terms of export-led industrialization, Japan long ago moved from textiles to steel and chemical industries, turning over its status of major textile exporter to Hong Kong. As Japan moved from steel and ship building to automobiles and electronics, Korea took over in steel and shipbuilding. Dynamic comparative advantage forces forerunners to vacate the markets for less sophisticated manufactured goods, allowing latecomers to take over those markets. See Ito (1997).

11 No country is immune from a potential currency crisis. No country would be safe if faced with a massive international capital outflow such as the one that took place in Southeast and East Asia in 1997. As discussed earlier in this paper, in 1996, there was a record capital inflow of $93 billion into Thailand, Malaysia, Indonesia, the Philippines, and South Korea, followed by a net outflow of capital of $12 billion in the following year 1997. This reversal of private capital flows of $105 billion was equivalent to 11 percent of the combined GDP of these five Asian countries. In terms of the U.S. economy, this would be equivalent to a change in capital flows of over $940 billion, which would no doubt wreak havoc on the U.S. financial markets!

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