HOW ASIA WORK

Success and Fa
in the World's
Dynamic Regio

JOE STUDWEL

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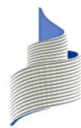
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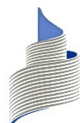
How Asia Works

JOE STUDWELL is the founding editor of *The China Economic Quarterly*. He has been a contributing writer to the *Economist* and was based in Beijing with the Economist Intelligence Unit. Previous books include *Asian Godfathers* and *The China Dream*.



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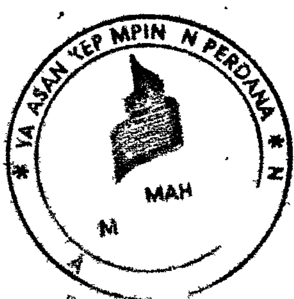

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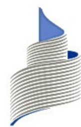
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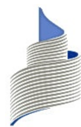
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Author's note

Two key data sources I have used are the International Monetary Fund's World Economic Outlook database, which starts from 1980, and the World Bank's World Development Indicators database, which starts from 1960. If no source is given for a data point, it has been taken from one of these two databases. The decision to not always quote the IMF and World Bank sources aims to reduce the number of endnotes.

The World Bank has changed its terminology and now refers to Gross National Product (GNP) as Gross National Income (GNI). While some readers may be used to the older term, GNP, GNI has been used throughout this book. According to the World Bank, there is no methodological difference between the two. The methodological difference that readers should take note of is that between GNI, which covers a country's income from both domestic and international sources, and GDP, which reflects income in the domestic economy alone.

Despite my efforts to contain the number of endnotes, there are still a good many that are necessary to elucidate a point or show that there is a substantive source for what I am saying. It is not expected or intended that readers will look up all the notes. The best way to proceed for many people will be to only turn to the endnotes if the point being made is one you consider particularly important or controversial. For those interested, I hope to publish more of the academic research that supports what I say in a separate addendum. Any progress on this front will be reported at www.howasiaworks.com.

Unless otherwise noted, exchange rates are those that applied in the year or period that is being discussed.

Finally, pretty much every country in Asia has produced competing systems of romanisation of Asian languages. In writing names of people and places, I have attempted to use the romanised forms that are most familiar to contemporary English language readers. Hence Deng Xiaoping is rendered in the mainland Chinese pinyin system, whereas Chiang Kai-shek is rendered in the Wade-Giles system favoured in Taiwan. In South Korea, a degree of romanisation anarchy reigns. The McCune-Reischauer system, the Yale system, the new Revised Romanisation

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system and more exist concurrently and Koreans take their pick when romanising their names. Moreover, there is no accepted convention for the hyphenation and capitalisation of given names. I have therefore followed expressed preference or what appears to be the most common usage. Park Chung Hee preferred to be styled thus. Ha-Joon Chang writes his name thus. Byung-kook Kim is styled thus. And South Korea's first president insisted on, and is still known as, Syngman Rhee (if I called him the more standard Lee Seung Man, no one would know him.) In North Korea, there is unanimity that Kim Il Sung is the way to style a name. In Indonesia I have avoided the older, Dutch-influenced spellings such as Soeharto, since post-colonial spelling, such as Suharto, is now very widely accepted. I apologise in the knowledge that in dealing with eight countries there will be some romanisation choices, and some name stylings, that readers disagree with.

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Introduction

This is a book about how rapid economic transformation is, or is not, achieved. It argues that there are three critical interventions that governments can use to speed up economic development. Where these interventions have been employed most effectively in east Asia – in Japan, South Korea, Taiwan and now China – they have produced the quickest progressions from poverty to wealth that the world has seen. When, by contrast, other east Asian states have set off with the same ambitions and equal or better endowments, but have not followed the same policies, they have achieved fast growth for a period but the progress has proved to be unsustainable.

The first intervention –and the most overlooked – is to maximise output from agriculture, which employs the vast majority of people in poor countries. Successful east Asian states have shown that the way to do this is to restructure agriculture as highly labour-intensive household farming – a slightly larger-scale form of gardening. This makes use of all available labour in a poor economy and pushes up yields and output to the highest possible levels, albeit on the basis of tiny gains per person employed. The overall result is an initial productive surplus that primes demand for goods and services.

The second intervention – in many respects, a second 'stage' – is to direct investment and entrepreneurs towards manufacturing. This is because manufacturing industry makes the most effective use of the limited productive skills of the workforce of a developing economy, as workers begin to migrate out of agriculture. Relatively unskilled labourers create value in factories by working with machines that can be easily purchased on the world market. In addition, in east Asia successful governments pioneered new ways to promote accelerated technological upgrading in manufacturing through subsidies that were conditioned on export performance. This combination of subsidy and what I call 'export discipline' took the pace of industrialisation to a level never before seen.

Finally, interventions in the financial sector to focus capital on intensive, small-scale agriculture and on manufacturing development provide the third key to accelerated economic transformation. The state's role is to keep money targeted at a

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development strategy that produces the fastest possible technological learning, and hence the promise of high future profits, rather than on short-term returns and individual consumption. This tends to pit the state against many businessmen, and also against consumers, who have shorter strategic horizons.

The policy prescription for rapid economic development was confused for a time in east Asia by the presence of other fast-growing economies that did not conform to the pattern of Japan, Korea, Taiwan and China. In the 1980s and early 1990s, the World Bank seized on the performance of the offshore financial centres of Hong Kong and Singapore, and the suddenly faster-growing south-east Asian economies of Indonesia, Malaysia and Thailand, to argue that economic development was in fact fostered by *laissez-faire* policies, with a minimal role for government. Despite the fact that the offshore centres, with their tiny, dense populations and absence of agricultural sectors to drag on productivity, are not really comparable to regular countries, the World Bank used Hong Kong and Singapore as two of its three 'proving' case studies in a highly controversial 1987 report.[1] After widespread academic criticism of the report, the World Bank followed up with another one in 1993, *The East Asian Miracle,* which admitted the existence of industrial policy and infant industry protection in some states. But it downplayed the significance of such policies, avoided discussion of agriculture altogether, and added Hong Kong and Singapore to Malaysia, Indonesia and Thailand, thereby leaving Japan, Korea and Taiwan as the statistical minority among its 'High Performing Asian Economies'. (China was omitted from the report.)[2]

This was the ideologically charged era of the so-called Washington Consensus, when the World Bank, the International Monetary Fund and the US Treasury were united in their determination that the free market policies coming into vogue in the US and Britain were appropriate to all economies, no matter what their level of development.[3] The vitriol of the debate was such that academic rigour was frequently a victim, as with the World Bank reports. Indeed, even the academic specialists on Japan, Korea and Taiwan who opposed the Washington Consensus position on economic development made suspect claims in order to bolster their case. This only added to confusion. Chalmers Johnson wrote in the preface to his seminal study of Japanese development, published in 1982: '[The Japanese development model] is being repeated today in newly industrializing states of East Asia – Taiwan and South Korea – and in Singapore and South and Southeast Asian countries.' Alice Amsden, who produced the defining deconstruction of Korean development, referred in the introduction to a follow-up book to 'the model used by Japan, Korea, Taiwan and Thailand'. Even W. W. Rostow, author of one of the earliest and most historically informed post-war books on economic development,

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The Stages of Economic Growth, declaimed in the foreword to a new edition in 1991 that Malaysia and Thailand were following Korea and Taiwan towards technological maturity.[4] In the argument over east Asia, everyone started to talk beyond their turf in an effort to win the debate.

The disagreement about the nature of economic development was only made possible by continued fast growth rates around the region. In the early 1980s, however, Brazil – the outstanding fast growth story of 1960s' and 1970s' Latin America – had shown how dangerous it is to judge economic progress by growth rates alone. Brazil is the only major economy outside east Asia which has managed to grow by more than 7 per cent a year for more than a quarter of a century.[5] But, with the onset of the Latin American debt crisis in 1982, Brazil crumbled amid currency depreciation, inflation and years of zero growth. It turned out that too much of Brazil's earlier growth had been generated by debt that did not translate into a more genuinely productive and competitive economy.

Beginning in 1997, with seven economies that have expanded at least 7 per cent a year for a quarter century – Japan, Korea, Taiwan, China, Malaysia, Indonesia and Thailand – east Asia entered a period of reckoning of its own, as the Asian financial crisis took hold. By this point Japan had long since become a mature economy that faced a new set of post-developmental structural problems, ones it showed much less capacity to address than the original challenge of becoming rich. Korea, Taiwan and China, however, were still in the developmental catch-up phase. These states were either unaffected by the Asian crisis or recovered quickly from it, and returned to brisk growth and technological progress. But Malaysia, Indonesia and Thailand were knocked completely off course. They suffered currency depreciation, inflation and much reduced growth. It is indicative that today Indonesia and Thailand report GDP per capita of only USD3,000 and USD5,000 respectively, and feature significant levels of poverty, where Korea and Taiwan report GDP per capita around USD20,000. At the end of the Second World War, all these countries were similarly poor.[6]

What the Asian crisis clarified was that a consistent set of government policy interventions had indeed made the difference between long-run success and failure in economic development in east Asia. In Japan, Korea, Taiwan and China, governments radically restructured agriculture after the Second World War, focused their modernisation efforts on manufacturing, and made their financial systems slaves to these two objectives. They thereby changed the structures of their economies in a manner that made it all but impossible to return to an earlier stage of development. In the south-east Asian states – despite their long periods of impressive growth – governments did not fundamentally reorganise agriculture, did not

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create globally competitive manufacturing firms, and *did* accept bad advice from already rich countries to open up financial sectors at an early stage. The Japanese economist Yoshihara Kunio had warned in the 1980s that south-east Asian states risked becoming 'technology-less' developing nations. This is exactly what happened, and they slid backwards when their investment funds dried up. In short, different policy choices created – and will probably further widen – a developmental gulf in the Asian region.[7]

The reality of two East Asias

The strategies – agricultural, manufacturing and financial – that determine success and failure were set in train decades before the Asian 'miracle' debate of the 1980s and 1990s took place. It is those strategies that this book explores. It begins with the radical redistribution of agricultural land in Japan, Korea, Taiwan and China in the late 1940s and early 1950s. Land was the biggest political issue in east Asia after the Second World War and promises of land reform were fundamental to the communist victories in China, North Korea and Vietnam. However, in these socialist states, family farming was later substituted, for ideological reasons, by collectivisation, which caused yields to stagnate or fall. In Japan, South Korea and Taiwan, household-based land redistribution programmes were implemented peacefully, and sustained. It was this that led to prolonged rural booms that catalysed overall economic transformation.

In south-east Asia there was also much post-war talk about more equitable land distribution, new agricultural extension services to support farmers and the provision of affordable rural credit. A good many reform programmes were launched. But the actual implemented effects were a fraction of what they were in the north-east of the region. This is where east Asian divergence began. The failure of the leaders of south-east Asian states to get to grips with the problems of agriculture both made development in general much more difficult and presaged other policy failures. It is instructive that sixty years later land is still a major political issue in the Philippines, Indonesia and Thailand, and only less so in Malaysia because the country's natural resource wealth mitigates its poor agricultural performance. Part 1 of this book explores why agriculture is so important. It does so partly through journeys to Japan and the Philippines.

Part 2 moves on to the role of manufacturing. It investigates how Japan, Korea, Taiwan and China perfected ways to marry subsidies and protection for manufacturers – so as to nurture their development – with competition and 'export discipline', which forced them to sell their products internationally and thereby become globally competitive. This overcame the traditional problem with subsidy

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and protection policies, whereby entrepreneurs pocketed financial incentives but failed to do the hard work of producing competitive products. Firms were not able to hide behind tariff and other barriers and sell only to a protected domestic market because protection, subsidies and credit were conditioned on export growth. Firms that did not meet the export benchmark were cut off from state largesse, forced to merge with more successful companies, or occasionally even bankrupted. Governments thereby ended up with world-beating firms to justify their considerable investments of public funds.

This is the second point at which there has been a sharp divergence of policy in south-east Asia and north-east Asia and China. In south-east Asian nations, leading entrepreneurs were no less capable than those in other countries, but governments failed to constrain them to manufacture and did not subject them to export discipline. Instead, there were state-sector manufacturing projects, but with little competition between firms and no requirement to export. As a result, governments obtained a very low return on all forms of industrial policy investment. In the boom years of the 1980s and 1990s, the failure to generate indigenous manufacturing and technological capacity was hidden by the arrival of high levels of foreign direct investment, much of it concentrated on processing operations within quite advanced manufacturing sectors. With the onset of the Asian crisis, however, the industrial difference between south-east and north-east Asia became starkly apparent. South-east Asia has almost no popularly recognisable, globally competitive manufacturing companies. Singapore's Tiger Beer and Thailand's Singha Beer and Chang Beer are about as close as we can get to widely recognised south-east Asian industrial brands, and these brewers are not really *manufacturers* at all. Without successful large, branded companies of their own, south-east Asian economies remain technologically dependent on multinationals, eking out a living as contractors for the lower-margin parts of international production chains. The manner in which states did, or did not, become masters of their industrial destinies is explored in part 2 during journeys to Korea and Malaysia, visiting the sites of their respective efforts to learn how to make steel and cars.

Part 3 looks at financial policy. In successful east Asian states, the structure of finance was determined by the need to achieve the objectives of high-yield, small-scale agriculture and the acquisition of manufacturing skills. To this end, financial systems in Japan, Korea, Taiwan and China were kept under close state supervision, and controls on international capital flows were maintained until an advanced stage of development. The main mechanism for making finance support state policy objectives was bank lending, which was manipulated to force export discipline on manufacturers. Firms had to demonstrate export orders in order to secure credit.

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In a neat circle, export performance also provided signals to banks about whether their loans would eventually be repaid, because exporters were almost by definition better businesses than firms that sold only at home. In order to fund development, interest on bank deposits in north-east Asia and China was set well below market rates, a form of stealth taxation that helped pay for subsidies to agriculture and industry. This encouraged the setting up of illegal deposit-taking institutions; however, these so-called 'kerb' markets never drained money from banks to a point that became destabilising.

In south-east Asia, countries were blessed with high levels of savings in their banking systems just as in north-east Asia. But governments directed the hefty investments this made possible to the wrong ends – to lower-yield, large-scale agriculture, and to companies that were either not focused on manufacturing or only on manufacturing for protected domestic markets. South-east Asian states then made their developmental prospects even worse by following rich country advice to deregulate banking, to open up other financial markets, and to lift capital controls. The same advice had been proffered to Japan, Korea, Taiwan and China in the early stages of their development, but they sensibly resisted for as long as possible. Premature financial deregulation in south-east Asia led to a proliferation of family-business-controlled banks which did nothing to support exportable manufacturing and which indulged in vast amounts of illegal related-party lending. It was a story of banks being captured by narrow, private sector interests whose aims were almost completely unaligned with those of national economic development. The process was one which has also been observed in Latin America and, more recently, in Russia. The detail of how financial liberalisation went wrong in south-east Asia is explored on a journey to Indonesia's capital Jakarta, where a new financial district grew like a mushroom in the run-up to the Asian financial crisis.

The countries covered

I have made a number of simplifications in this book so as not to dilute its central messages and to enable its story to be told (endnotes excepted) in just over 200 pages. One of these involved choosing which east Asian countries to leave out of the narrative. Since the book is about developmental strategies that have achieved a modicum of success, the region's failed states do not appear. North Korea, Laos, Cambodia, Myanmar and Papua New Guinea, all of which are found near the bottom of the United Nations' Human Development Index (HDI) rankings,[8] are not discussed. The reasons for the failure of these states are varied, but one common characteristic leaps out: they are all politically and economically introverted. In varying degrees, these countries are re-learning the old lesson of pre-1978 China, pre-1989 Soviet

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