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REVIEW OF THE ROLE OF GOVERNEMENT IN EAST ASIAN ECONOMIC DEVELOPMENT, CLARENDON PRESS OXFORD 1997, AOKI, KIM & OKUNO-FUJIWARA (EDITORS)

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I

This is an important and ambitious book but its timing could not be more unfortunate. It is the result of a two year research project co-sponsored by the Economic Development Institute (EDI) at the World Bank and by the Center for Economic Policy Research at Stanford University. The contributors who are based in the US, Japan, Korea and Malaysia are all leading experts in the subject. The book was apparently completed in October 1995; it therefore predates the current acute economic and financial crisis in the East Asian countries.

The authors' main objective is to explain why government interventions apparently succeeded in East Asia whilst they have failed elsewhere. What lessons concerning the role of government should developing and developed countries draw from the East Asian experience? Using theoretical and comparative institutional analysis, the authors attempt to identify the nature of government interventions, the conditions under which they are likely to aid economic development and the circumstances in which they would hinder it.

The present economic meltdown in East Asia, however, raises an opposite set of questions. These are being asked, not without a degree of triumphalism, by financial journalists and popular commentators in the West. Significantly, serious analysts and policy makers at the highest levels also suggest that the present Asian crisis was a disaster waiting to happen in view of the dirigiste model of capitalism which East Asian countries had been following. Thus Alan Greenspan, the cautious and highly respected Chairman of the US Federal Reserve, told the Senate Relations Committee last spring that the dismantling of the Berlin Wall in 1989 symbolised the end of Socialism as a way of organising economic activity. This, however, left the world with two kinds of capitalism - the Asian kind and the free-market Western kind. Greenspan goes on to say that as long as this Asian capitalism generated growth rates of 10% p.a. it was difficult to fault it; nevertheless, it was clear all along that the underlying structures of this alternative capitalism were faulty. [Quoted in Singh (1998)]

The IMF has adopted a similar view of the Asian crisis. It has suggested that whatever the immediate triggers for the crisis (for example, the short term macroeconomic imbalances or property market bubbles) its 'deeper' causes were 'structural'. These derived effectively from the Asian model of capitalism which led to cronyism, over-investment, lack of competition and disregard for profits. Therefore, in its adjustment programmes for the crisis affected Asian countries the IMF's conditionality requires fundamental structural changes in the existing systems of corporate governance, labour laws, the relationship between banks and business, and capital market regulation both internal and external. In short, the Fund would like Asian countries not only to radically alter their traditionally close government/business relationships, but to have a much diminished role for the government in economic activity altogether.

Be that as it may, it is still important for economists to ask why the Asian countries grew so fast for such a long and sustained period. It is no exaggeration to say that the industrialisation of Japan and East Asian NICs in the post-World War II period has been the most successful example of fast economic growth in the history of mankind. Why and how did this happen and what role did the government play in the process? Notwithstanding the current crisis, these questions will remain extremely important both for economic theory and economic policy. The crisis, of course, raises equally legitimate questions concerning the causal connection between government economic interventions and the kind of serious difficulties these countries presently find themselves in.

The papers in this book provide answers only to the first set of questions. Nevertheless, towards the end, the review will also comment on the second set of questions in relation to the authors' analyses.

II

The role of the government in the East Asian economic miracle has long divided economists and there is still no consensus - except now at long last on the fact that the government intervened heavily in these economies. [For citations to the large literature on the subject, see Singh (1994, 1997)]. The Bretton-Woods Institutions (BWIs) have been leading participants in this debate; their contributions are the starting point of this book. To put the analyses of the book into perspective, it is important to note that the BWIs theses on East Asian development have undergone three major transformations in the last seven years. The World Bank's 1991 seminal publication, which was supposed to represent what the Bank economists had learnt from forty years of development experience, investigated the following question: why did a country like Japan which at the end of the war was under-developed and in serious economic difficulties succeed so spectacularly whilst many others failed. The Bank economists concluded that Japan and other East Asian countries had followed a 'market friendly' strategy of development. 'Market friendly' was defined as meaning that the state did not intervene actively in the economy but rather had a night watchman role of providing the infrastructure, the legal framework etc. for the private sector to flourish. In response to the criticisms from the academic community that this was not an accurate reading of the historical record, the Bank in another major contribution (World Bank 1993, hereafter called the EAM -the East Asia Miracle) conceded to its critics and acknowledged that government interventions in East Asia were extensive and far-reaching and went far beyond the 'market friendly' definition. However, at the policy level the EAM did not budge very much from its previous stance - insisting that the most useful policy for developing countries was still to get the 'prices right', to follow their comparative advantage and basically to implement the 'market-friendly' strategy of development.

Nevertheless, as the contributors to the volume under review note, the EAM represented, at a theoretical level, a path-breaking advance for Bank economists in their analysis of economic development. Among other things, the EAM provided a sophisticated discussion of co-ordination failures in market economies and introduced several new concepts to reconcile the East Asian experience with economic theory, e.g. deliberation councils to describe a significant aspect of government/business relationships and their positive merits in addressing co-ordination failures. The government practice in East Asia of setting performance targets for corporations with respect to exports was conceptualised in terms of arranging 'export contests'. Such contests were thought to simulate competition and hence enhance economic efficiency.

The third stage of the BWI's analysis of East Asian development comes with the IMF's examination of the current Asian crisis, referred to earlier. The current thesis of the IMF

(1997) seems to have come full circle: the close government/business relationships and the deliberation councils are now apparently being viewed negatively as fostering cronyism and misallocation of resources rather than correcting co-ordination failures.

III

The contributors to the volume under review are broadly sympathetic to the EAM's general approach - many of them were associated with the preparation of the EAM. They are, however, also critical in the sense that they do not think it goes far enough, is too eclectic and is in some respects misleading. The editors, Aoki, Kim and Okuno-Fujiwara, situate the contribution of their book as a third way between the 'market friendly' strategy and the 'developmental state' view of the role of the government in economic development. In a brilliant introductory chapter, Aoki, Kim and Okuno-Fujiwara use the insights from game theory, transactions cost theory, contracts theory and information theory to analyse the role of the government in advancing economic development. The essential argument is that co-ordination problems are ubiquitous in market economies: among other things they arise from information asymmetries or other informational deficiencies; non-convexities; execution of large investment projects with strong complementarities. Such difficulties are likely to be particularly severe in developing countries where markets are likely to be even more incomplete or missing altogether than in advanced economies. The co-ordination problems can sometimes be solved by private bargaining, but often this may not be possible and state intervention is required. The authors' central thesis however is that instead of the government intervening directly to achieve co-ordination, it should do so as far as possible indirectly by encouraging private organisations including firms, banks, trade associations and other civil society organisations to carry out this task. The intuition behind this proposition is that the central government does not have the local information available to lower level organisations. The authors call this the 'market-enhancing' view which is perhaps a misnomer: it should more aptly be called the 'visible hand' analysis of markets in economic development.

Aoki, Kim and Okuno-Fujiwara introduce several additional elements into this basic theoretical framework, e.g. path dependence, a taxonomy of rents including particularly the concept of contingent rents (the government accords these to economic agents contingent on their meeting certain performance standards). The framework enables the authors to argue that the best way to investigate economic growth and to assess the role of the government is through comparative institutional analysis. There is no single universal formula to indicate when and which government interventions would be successful. It depends among other things on the level of economic development, the past history of the country and the competence of the bureaucracy.

Other chapters in this book use case studies, historical and country experiences as well as sectoral studies to examine the efficiency of government interventions in different contexts. Although the authors do not always agree with each other and sometimes use different concepts, the analytical framework of the introductory essay does help to give the volume an intellectual coherence. Many of the essays provide rich historical or analytical contributions to the subject to which it is not possible to do full justice in the space of this review. Nevertheless what struck the reviewer as some of the interesting and important points made in a few of the other chapters are outlined below.

Lawrence Lau examines the role of the government in the economic development of China, Taiwan and Hong Kong. One of the more interesting observations he offers is that Deng Xiao-Ping's visit to South China in 1992 and his strong affirmation of the Chinese government's new economic policies helped to co-ordinate expectations and lift the country from a low growth to a high growth equilibrium. It led to the resumption of economic expansion and China's subsequent boom after the slow-down in the post-Tiananmen period. Indeed he suggests that this visit may have strengthened economic growth not only in China but also in Taiwan and Hong Kong.

Using newly available historical information for the period, Tetsuji Okazaki investigates the critical role of the government in the simultaneous development of steel, coal, shipbuilding and machinery industries in Japan in the 1950s. It is suggested that an important reason for the government's successful intervention were the high complementarities between the industries and the large scale of the investments required. This is indeed true but nevertheless it should not be forgotten that to have undertaken such a project at the time would have required not only considerable courage but also a great deal of vision and imagination. In the mid 1950s, Japan produced only 5 million tons of steel and 30,000 motor cars p.a.. The US at that time produced 90 million tons of steel and 7 million cars p.a. Japan was mainly an exporter of textiles and light manufacturing good. Further Krueger (1995) has recently reminded us, the value of Japanese exports in 1952 was lower than that of India's. It did not have the main raw materials for producing steel. The conventional wisdom of the time suggested that possession of raw materials and their close proximity to each other was a necessary condition for low cost steel production. The successful completion of this industrial programme by Japan which could not have occurred without the government's crucial co-ordinating role has confounded this belief for ever.

Kiminori Matsuyama's chapter outlines the nature of the co-ordination problem when the assumption of fixed knowledge is not valid. In a world of uncertainty and fast-moving technological developments which cannot be foreseen the co-ordination problem becomes much more serious. In these circumstances, local level co-ordination and experimentation may be more optimal than co-ordination by central government.

Thomas Hellmann, Kevin Murdock and Joseph Stiglitz' chapter is concerned with the informational and co-ordinational problems of the financial sector. They put forward an important new theory of 'financial restraint' in which the government restricts deposit rates and imposes other regulatory constraints on banks. The authors show these to be Pareto-superior to the laissez-faire policies. They also point out that financial restraint differs from financial repression in the sense that low deposit rates are established not to benefit the government but to improve the efficiency of the banking system. The authors' analysis shows that developing countries should give precedence to the development of banks before establishing stock markets. Once a sound banking system is in place, a country can then make an informed choice whether to move towards the bank-dominated German-Japanese model or the stock market dominated Anglo-Saxon one.

Cho's excellent chapter on Korea notes the state's extensive involvement in the financial markets: it owned the banks, controlled interest rates and directed a substantial portion of bank credits. The government control over financing was a major instrument for implementing its industrial policy. Cho notes that the "risk of government failures" was reduced by the "government's continuous communication with business leaders and close monitoring of firms". The government pushed the chaebol towards upgrading their technology and producing an ever-widening range of technologically more advanced products. In a developing country such production carried enormous technological risks for the individual firm. Without the government's involvement as essentially co-partners and effective socialisation of the risk, the chaebol would not have been able to undertake such high risk projects. Overall, Cho deems these deep state interventions during the last four decades to be successful from the perspective of the real economy and industrialisation. However, he also suggests that a legacy of these policies was an under-developed banking system.

K S Jomo and Edmund Terence Gomez' long essay on rents and economic development in Malaysia provides a fascinating account of the changing role of rent creation, distribution and deployment in that country during the last four decades. Their distinction between and analysis of developmental and redistributive rents are particularly insightful, The latter are designed to redistribute income and wealth from the minority Chinese community who own the country's wealth to the majority Malays (Bhumiputras) who have the political power.

IV

I turn now to the question of timing referred to at the beginning of the review. Do recent events in East Asia negate the analysis of the book that the state interventions in these economies have generally been beneficial in addressing co-ordination problems? Were the underlying structures faulty, as suggested by Greenspan and the IMF, which led to cronyism, lack of transparency, over-investment, a disregard for profits and ultimately to the crisis. These issues have been investigated in detail in Singh (1998) and in Singh and Weisse (1998). The results do not provide any support for the IMF/Greenspan theses. At the outset these face an important difficulty: the structural factors should not simply explain the current crisis but also why the same structures were so successful for so long. There was indeed over-investment and a fall in profits as well as misallocation of resources (e.g. the property bubble in Thailand). However, these were not due to too much government intervention in the economy but rather to too little. In the period immediately preceding the crisis, governments like Thailand and Korea's had begun to implement financial liberalisation which led to the abandonment of government co-ordination and controls over the allocation of investments as well as the close monitoring of borrowings abroad by large corporations and financial institutions. It was the lack of co-ordination of corporate investment decisions which led to the observed phenomena of low profits and high investment. The unfortunate and incorrect analysis of the crisis by the IMF in the early stages suggesting that these economies had serious long term structural faults panicked the investors and further deepened the crisis. [ie.the IMF's pronouncements, contrary to those of Deng in 1992 mentioned earlier, managed to co-ordinate expectations in the downward direction and helped produce an even worse equilibrium than before, Feldstein (1997)].

V

Although the current crisis in East Asia does not in any way diminish the value of the contribution of this book in understanding the role of the government in the extraordinarily successful industrialisation of the region in the second half of the twentieth century, it nevertheless reveals certain weaknesses in the theoretical framework. Aoki, Kim and Okuno-Fujiwara's argument is micro-economic and their preference for local level co-ordination makes sense in that context. However, the theoretical framework does not explicitly consider the question of macro-economic co-ordination as well as the important connections between co-ordinations at the micro- and macro-economic levels. When macro-economic co-ordination fails either because of external shocks or internal political difficulties resulting in a crisis, it becomes more difficult to effect micro-economic co-ordination as well. In the past, the East Asian governments have been particularly adept at ensuring the necessary macro-economic balances (between savings and investments as well as the current account) at high growth rates. Industrial policy and micro-economic co-ordination were important instruments to maintain such macro-economic balances. The government however also used other measures to achieve these macro-economic equilibria including not just monetary and fiscal policy but also policies to enhance savings and so on. Clearly, macro-economic co-ordination can only be done at the level of the economy as a whole and not at the local level. Nor can it be taken for granted that it will always be carried out adequately by a government which is successfully able to implement an industrial policy, as the recent experience of Japan and East Asian countries illustrates. These matters need to be studied further.

VI

To sum up, for the reasons outlined in the review, this is an important book which deserves to be widely read for its theoretical as well as empirical analysis of micro-economic co-ordination problems at various stages of economic development. The general standard of papers is exceptionally high. Recent events in East Asian countries do not detract from the value of their contribution but suggest important areas for further research.

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