Economic development in East Asia: What works (and what doesn't)

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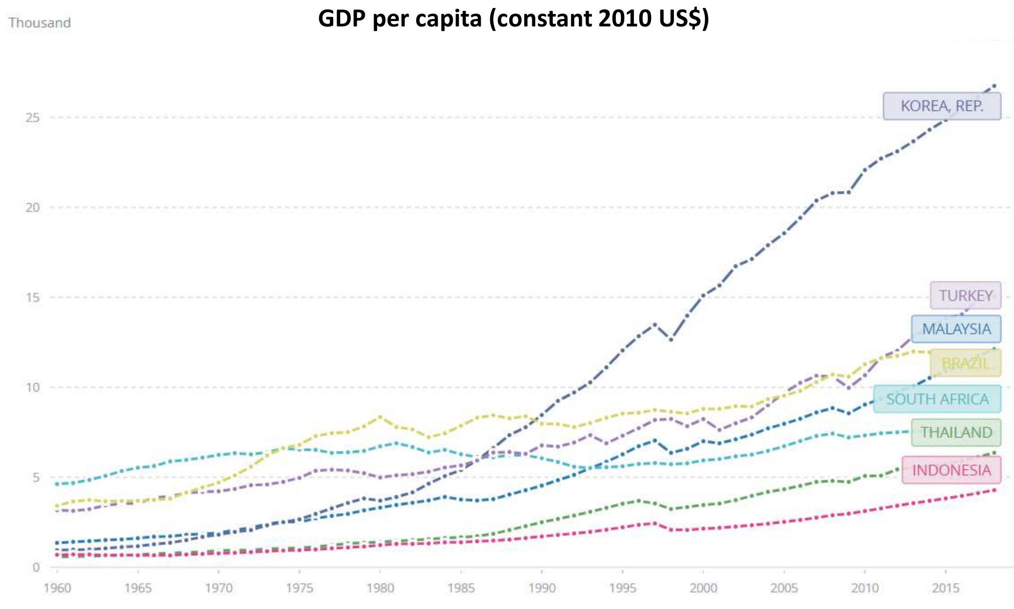
1

GDP per capita (constant 2010 US$)



2

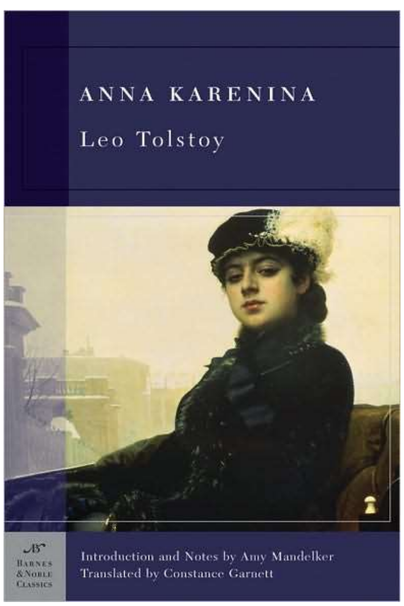
The Middle-Income Trap (MIT)

- The World Bank (2012) found that of the 101 middle-income (MI) economies in 1960, only 13 had graduated to high income (HI) status by 2008.
  - Japan, South Korea, Taiwan, Hong Kong, Singapore
  - Spain, Portugal, Ireland, Greece
  - Israel, Mauritius, Equatorial Guinea, Puerto Rico

- Felipe et al (2012) define countries in the MI trap as those that remained at:
  - $2,000-$7,500 for over 28 years; and
  - $7,500-$11,500 for over 14 years

- Kharas and Kohli (2011) argue that today's middle-income countries are caught in a *developmental nutcracker*; they are "unable to compete with low-income (LI), low-wage economies in manufactured exports and unable to compete with advanced economies in high-skill innovations."

3



"Happy families are all alike; every unhappy family is unhappy in its own way."

4

Centrality of Land Reform

- Studwell (2013) argues that the post-war miracle economies of Northeast Asia succeeded by following a recipe with just three basic ingredients:
  - **Land reform** combined with agricultural extension services
  - State-led, **export-driven industrialization**, combined with the requirement for firms to compete domestically
  - **Financial repression** to limit the outflow of scarce capital and to ensure that capital is allocated to productive uses, especially agriculture and export-oriented manufacturing

- In Japan, South Korea and Taiwan, feudal estates were broken up and divided among small famers, who also received cheap credit and agronomic advice and training.

- Smallholder farming, while less efficient than mechanized farming (in terms of yields per farmer), was superior in terms of utilizing available labor to *maximize yield*.

- Land reform, by maximizing yields, serves a number of developmental goals:
  - Farmers have more money to spend on local manufactures
  - Higher food output reduces the leakage of scarce foreign exchange on imports
  - Farmers' savings can be recycled into export-oriented manufacturing
  - Countryside becomes a "laboratory for capitalism"; many successful industrial firms started out by selling manufactured goods to farmers (e.g. Toyota, Mazda, Hyundai, Haier, Huawei, Great Wall Motor, Wanxiang)

5

Meanwhile, in MIT countries…

- Land reforms that didn't go far enough, and agricultural policies which favored large agribusinesses and plantation owners over smallholders and tenant farmers.

- Industrial policies that did not impose export discipline or domestic competition between firms and failed to ensure technology learning and develop the country's technological capacity.

- Premature financial liberalization that dissipated the nation's developmental capital and led to the Asian financial crisis.

- Lack of investment in human capital and the absence of upgrading coalitions necessary for R&D and the transformation of the economy into a productivity and innovation-led one.

6

Industrial Policy

- **Why does a developing country need to industrialize?**

  - A country cannot sustain development on agriculture and commodities alone. The next phase of development has historically revolved around manufacturing.
  - Manufacturing is critical to rapid growth of poor countries because it allows countries to mitigate their lack of skilled workers through the use of easy-to-operate machinery. (In contrast, it's much harder to teach unskilled workers to work in ICT or financial services.)
  - Machines allow manufacturing sector to 'scale up' its production much more than in services, which are much less amenable to rapid productivity growth.
  - Trade in manufacturing is much greater than trade in services, which tend to be more domestic in orientation (with the exception of ICT and to some extent, financial services).
  - Trade is also essential to economic development; it allows poor countries to learn productive skills from more advanced economies and acquire new technologies.

7

Should governments engage in industrial policy?

Leave it to the private sector

- An economy should focus on its "natural" comparative advantages.
- Avoid industrial targeting: governments run into severe *informational* and *incentive* problems when they try to pick winners (public choice theory).
- Industrial policy increases the risks of government corruption and misallocation of resources, and often encourages rent-seeking behaviors from domestic firms.
- Export subsidies and import tariffs insulate domestic producers from competition, reducing incentives for them to be efficient and innovative.
- Hence, governments should invest only public goods and "sector-neutral" infrastructure.

Public sector must lead

- An economy can create its own comparative advantage; without state promotion/support, certain industries/markets would not emerge.
- Industrial policy can develop capabilities in new growth areas and enable economic diversification.
- Without government support, promising new industries cannot survive against global competition (infant industry argument).
- New industries often require *specific* inputs that can only be provided by the state, or the benefits of "discovery" cannot be fully internalized (externalities argument).
- Spillovers, network externalities and other coordination failures impede the growth of new industrial clusters.

8

Industrial Policy

- Manufacturing firms are nurtured by the state in two ways: **protection** and **subsidy**. Industrial policy has been pursued widely but has seldom produced results in developing economies.
- The challenge for industrial policy is to align the goals of domestic entrepreneurs with national developmental goals (i.e., industrialization, export competitiveness, expand and deepen the country's technological capabilities.)
- *How* industrial policy is pursued and implemented matters far more than the fact that it is pursued. Governments in northeast Asia mostly succeeded in nurturing domestic industry while those in Southeast Asia failed miserably.
- So why did northeast Asia governments succeed in industrial policy while those in Southeast Asia mostly failed?

9

Industrial Policy in Northeast Asia

- In northeast Asia, industrial policy succeeded because of:
  - **Export Discipline**: Continually testing and benchmarking domestic firms that enjoy subsidy and market protection by forcing them to export their goods and face global competition. Without export discipline, "development policy has become a game of charades, with local firms (pretending) they have been achieving world-class standards without having to prove it in the global marketplace."
  - "In southeast Asia, the energies of entrepreneurs were directed towards fooling politicians rather than exporting… They also drained away their nations' developmental capital, redirecting much of it into excessive real estate development that culminated in the real estate bubbles associated with the Asian financial crisis."




10

Industrial Policy in Northeast Asia

- The second factor was **competition between domestic firms** and the willingness of industrial policymakers to cull those firms that did not measure up. "In Japan, Korea, Taiwan and China, the state did not so much pick winners as weed out losers." In contrast, industrial policy in Southeast Asia often meant giving concessions or licenses to monopolistic local firms.
- Competition between firms meant that industrial policy **weeded out losers** rather than picked winners. This helps to explain the large businesses that grew without significant state support, e.g., Sony and Honda in Japan, Samsung in Korea, HTC and Acer in Taiwan.
- The third difference in northeast Asia was the relatively high level of **embedded autonomy of the developmental states** and the extensive **bureaucratic support** given to manufacturers which exported successfully, e.g. domestic market protection (via import tariffs), access to subsidized credit and foreign exchange (so as to import capital inputs), and support for technology acquisition.
- Key role of agencies which combined industrial and foreign trade policy decisions, e.g., MITI in Japan, EPB in Korea, IDB in Taiwan and the NDRC in China.

11

Meanwhile, in MIT Economies…

- Inadequate or non-existent land reforms that contribute to vast wealth and income inequalities, as well as spatial inequality
- Some were partially successful in industrialization, but industrial policies often lacked export discipline, and often did not require firms to compete with one another.
- Reliance on FDI to drive industrialization resulted in weak indigenous technological capacity and created cleavages between local and foreign businesses, between formal and informal labor, impeding subsequent upgrading efforts.
- Premature financial liberalization that led to excessive real estate development, financial speculation, and inadequate investments into developmentally useful but privately less profitable activities
- Inadequate investments in STEM education and R&D. Upgrading coalitions and institutions are weak or non-existent.

12

Economic development in Southeast Asia

Malaysia

- Dr Mahathir was unique among Southeast Asian leaders in his commitment to industrialise his country based on the northeast Asian experience.
- But there wasn't sufficient understanding of the critical prerequisites of successful industrial policy – that state support must be combined with **export discipline** and a hard-headed willingness to **cull losers**.
- Malaysia's mistakes:
  - Failed to impose export discipline;
  - Rarely employed the private sector to lead industrial investments and did not create competing enterprises.
  - The state picked winners but did not enforce competition to weed out the weak.
  - Mixed industrial policy with affirmative action objectives.
  - Inadequate investments in education and technological upgrading; bureaucracy wasn't strengthened
- Domestic entrepreneurs went into "distributive" sectors – commodities, power generation, real estate and finance – instead of the productive sectors.

13

Economic development in Southeast Asia

Indonesia

- Suharto was influenced by Mahathir's Look East industrialization policies in the 1980s
- But like Malaysia, the state imposed no export discipline and very little domestic competition
- There was also insufficient pressure to push firms up the technological ladder so local manufacturers were entirely dependent on foreign firms for technology.
- While manufacturing is about 20 percent of GDP, much of it is low value-added or done through joint ventures to serve the domestic market.

14

Economic development in Southeast Asia

Philippines

- After the war, the Philippines continued to rely on its agricultural sector. The Filipino elite built up its estates and plantations while fiercely opposing any political effort to make entrepreneurs manufacture for export.
- There were no businesses subject to genuine export discipline for the Philippine National Bank formed to fund Filipino development to lend to.
- From the 1950s, the Philippines became “east Asia’s IMF and World Bank junkie”, with more programmess and efficiency plans foisted on it than any other state in the region to prevent its financial system from collapsing.
- Privatisation of the banking system was a typical prescription of the international financial institutions. But the banks became the personal piggy banks of the oligarchic, plantation-owning families, with the costs of their misadventures picked up by the state.
- Marcos came to power in 1965 promising land reform and industrial development but did neither. Preferential credit did not have any special focus on exports, nor was there an industrial strategy that would lead to exports.
- In the latter years of Marcos’ rule, the banks of his leading cronies funded their own families’ assets, almost all of which exported only commodities. They contributed nothing to industrialisation (unless one counts beer and rum production).
- Under Marcos, Philippines ran up large foreign debts, which did not go into building up industrial capabilities, but to real estate development, vote-buying, and non-productive imports.

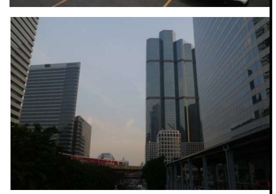
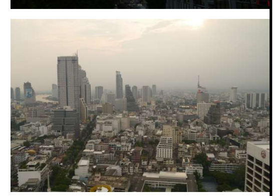


15

Economic development in Southeast Asia

Thailand

- Pursued import substitution policies from 1950s to 1980s
- Competent bureaucracy, orthodox fiscal and monetary policies
- No pressure on protected manufacturers to export; depended on domestic market
- ISI based on low import tariffs on components and high tariffs on finished goods. While this led to assembly joint ventures with foreign firms, there was little technological learning.
- Thailand was the world’s fastest growing economy in 1987-96 but this did not signify long-lasting economic development.
- A real estate boom began in the late 1980s as a result of financial liberalization and accelerated markedly in the 1990s.
- As the asset bubble inflated, Thailand acquired an annual current account deficit of 5-8% of GDP. This alone was enough for currency traders to take short positions against the Thai baht, precipitating the Asian financial crisis.
- Thailand suffered the worst initial economic contraction of any country in east Asia. The IMF insisted on the anti-spendthrift, anti-inflationary medicine it had developed in Latin America in the late 1980s. But since Thailand’s problem was not with inflated government budgets, expenditure cuts and tax rises sent the economy into tailspin, contracting 14% in domestic currency terms between 1996 and 1998.
- The IMF’s star pupil saw its growth forecast plunge from 3.5% to -7% in just a year. It was not until 2003 that Thailand regained its 1996 GDP.

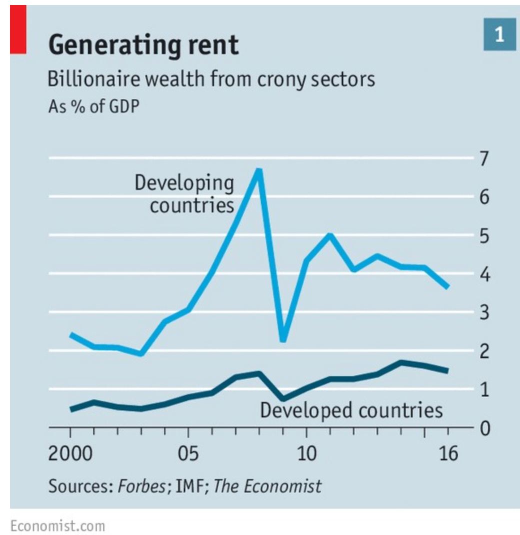




16


Where the living is easy

Rent-seeking sectors included in index

Rent-seeking sectors included in index
Casinos
Coal, palm oil and timber
Defence
Deposit-taking banking and investment banking
Infrastructure and pipelines
Oil, gas, chemicals and other energy
Ports, airports
Real estate and construction
Steel, other metals, mining and commodities
Utilities and telecoms services



17

18

Lessons from East Asia

- Unlike their Northeast Asian counterparts, Southeast Asian governments **failed to industrialize successfully and develop indigenous technological capabilities**. As their firms can easily make money domestically in protected environments, they were unwilling and unable to compete globally.

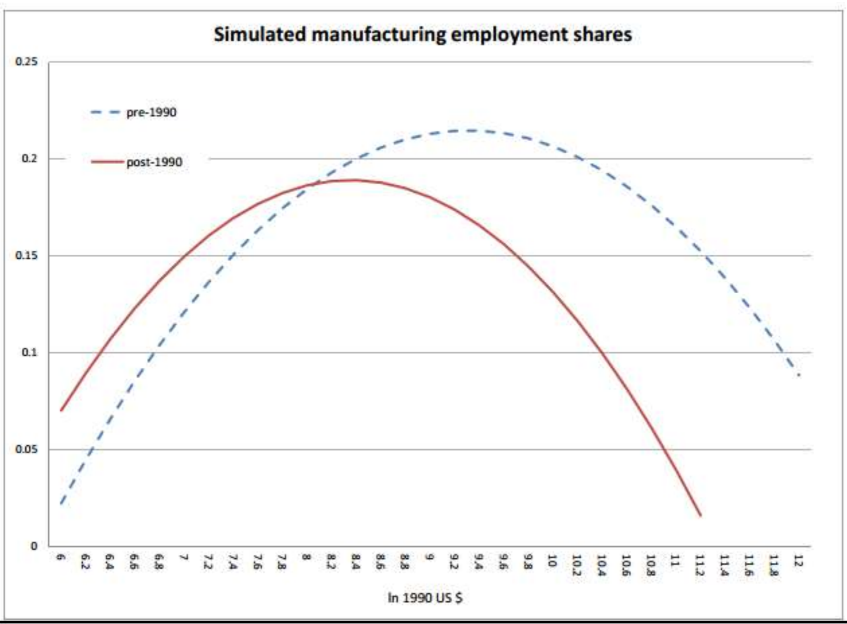
- The unwillingness of their governments to create domestic competition also created serious **principal-agent problems**. The energies of their entrepreneurs were directed at fooling politicians and rent-seeking rather than at manufacturing and exporting. They directed the countries' capital at the sectors with the highest financial returns, i.e., real estate, finance, commodities, power and utility concessions.

- Long-lasting **economic development is different from short-term GDP growth** and is dependent on technological and industrial development. Short-term GDP growth can be generated by real estate and stock market booms, fuelled by consumer lending and spending, but these invariably end badly – as the Asian and global financial crises demonstrate vividly.

- Centrality of **state direction in the allocation of capital**: The successful Asian developing state **points financial institutions at the necessary export-oriented infant industry policies**. The state also closes off the possibility that finance will look to alternative opportunities, or that foreign capital inflows will disrupt its plans.

19

Premature deindustrialization



20

THANK YOU