DEVELOPMENT CENTRE SEMINARS

GROWTH AND COMPETITION IN THE NEW GLOBAL ECONOMY

EDITED BY
ULRICH HIEMENZ

OECD DEVELOPMENT CENTRE
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DEVELOPMENT CENTRE
OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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The purpose of the Centre is to bring together the knowledge and experience available in Member countries of both economic development and the formulation and execution of general economic policies; to adapt such knowledge and experience to the actual needs of countries or regions in the process of development and to put the results at the disposal of the countries by appropriate means.

The Centre has a special and autonomous position within the OECD which enables it to enjoy scientific independence in the execution of its task. Nevertheless, the Centre can draw upon the experience and knowledge available in the OECD in the development field.

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DANS LA NOUVELLE ÉCONOMIE MONDIALE

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Foreword

This work is based upon a joint conference organised by the OECD Development Centre, the Korean Development Institute and the International Center for Economic Growth in June 1996. It was undertaken in the context of the Development Centre's programme on global interdependence.

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Preface

The economic landscape of the world economy is undergoing considerable change as more and more countries implement far–reaching economic policy reforms. Many of these newly emerging economies have developed, or will soon develop, close economic linkages with OECD countries and become increasingly influential partners in international transactions of goods and capital. This group of newly emerging economies includes both countries in transition and those undertaking major policy reforms: Latin American countries — in particular Chile, Argentina and Brazil; Central European countries in transition; India; and many other Asian economies, including those in transition, such as China and Viet Nam. While the integration of these countries into the world economy poses considerable challenges to the flexibility of OECD countries to adjust to increasing competition, the reforming countries themselves are subject to international pressure and uncertainties, as the current financial crisis amply demonstrates. These countries face — no matter how different initial conditions were — a common set of internal problems including macroeconomic stabilisation, enterprise and banking reform as well as correcting social imbalances. These problems must be addressed if the momentum of reform is to be maintained, especially in the wake of the current crisis.

The OECD Development Centre, the Korea Development Institute (KDI) and the International Center for Economic Growth (ICEG) jointly organised a conference focusing on these common internal and external challenges to the newly emerging economies. The meeting was intended to intensify the policy dialogue with policy makers from these economies on the basis of presentations looking to the 21st century and how changes in the world economy might affect newly emerging economies. The two–day Seoul conference brought together policy makers from each of the following regions: Latin America, Central Europe, South Asia and East Asia.

Major topics for discussion were the driving forces behind globalisation, macroeconomic interdependence in a world characterised by free movement of capital flows, the establishment of adequate domestic institutions, the reform of national financial markets, and employment generation and poverty alleviation. The discussions led to comparisons of experiences in a wide range of countries across three continents.

Our organisations are pleased to place this important body of research at the disposal of policy makers and the academic community.

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President
OECD Development Centre

Dong–Se Cha
President
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September 1998

Introduction

Ulrich Hiemenz

As more and more countries implement far–reaching economic policy reforms to participate in the process of globalisation, they considerably change the world's economic landscape. Many of these newly emerging economies (NEEs) have developed or soon will develop close economic links with OECD countries; they will become increasingly attractive and influential international partners in the goods, services and capital markets. They exist throughout the world. Some wrestle with the problems of transition from planned to market–based economies. Others include more classically "developing" economies, now struggling to make major reforms in policy regimes of the past.

The integration of these countries into the global economy raises two challenges. The OECD countries must adjust, flexibly, to increasing competition. The reforming countries themselves face international pressures and uncertainties which could impede their reforms — and, whatever their initial conditions, all face a common set of internal issues, most notably macroeconomic instability, enterprise reform and social inequities.

These challenges have to do with policy and they demand internal and international dialogue. To further that process, the OECD Development Centre, the Korea Development Institute (KDI) and the International Center for Economic Growth (ICEG) jointly organised a two–day conference in Seoul on 27–28 June 1996, specifically oriented towards policy issues facing the NEEs. The conference brought together 20 policy makers from Latin America, Central Europe, South Asia and East Asia. A lively discussion proceeded on the basis of the expert papers presented in this volume.

The papers — which introduce many points of view to the debate — offer a stimulating tour from the general to the particular and cover most of the main issues with which policy makers struggle. Helen Hughes leads off with a sweeping, often provocative overview that places all of the main issues in the double context of post–war economic history and the challenges of the immediate future. Charles Oman follows with an equally integrative treatment of the grand themes of globalisation and regionalisation, placing them in the context of his intriguing view of the major *microeconomic* forces which drive globalisation today. Usefully informative differences of viewpoint already begin to emerge in these two papers.

A group of issue–oriented papers follows: Maxwell Fry on fiscal policy and financing fiscal deficits; Gary Fields on labour markets and trade policy; and Kiichiro Fukasaku and Lisbeth Hellvin on inflation and open–economy monetary policies. In juxtaposition, these pieces suggest more than a start towards consistency in policy regimes that must in the real world deal with all of these issues at once.

The final group of three papers moves essentially into specific national reform experiences. These pieces stress diversity but seek commonalities which policy makers might seize upon and adapt. They also highlight different approaches to policy, and explicitly or implicitly stress the importance of both formal and informal institutions in fostering fast growth and economic change. Chung Lee and Jungho Yoo both look at Korean policies in the 1960s and 1970s and their antecedents. Lee takes a strongly institutionalist point of view to argue that government intervened correctly in those decades. Yoo draws more or less the opposite conclusion, arguing that openness to world markets rather than interventionist industrial policy offers the surer path to fast industrialisation and growth; drawing on a global historical analysis over more than a century, he offers an original perspective on *why* this may have more truth now than in the past. Sumner La Croix, Shelley Mark and Wing Thye Woo look at policy reform in two very large countries, China and India. They ask — and answer — which policy approaches used in China could or could not find useful application in India as a relatively "late mover" in economic policy reform.

In the debates on these papers, the participants — policy makers and experts alike — agreed that globalisation requires continued economic reform in all countries. Many common views emerged on the elements essential to such reform, especially:

— political will and credible government action;

— adequate institutions that support reform;

— human resource development; and

— a stable macroeconomic environment.

These fundamentals determine countries' competitive positions in international markets for goods, services and mobile factors such as capital and technology. Success in competition becomes the essential prerequisite for growth, without which, all agreed, social development becomes unlikely.

Serious unresolved policy problems also emerged:

— appropriate ways to create the right institutions for individual societies;

— the dangers of regional protectionism;

— the destabilising effects of large, volatile capital flows;

— the developmental impact of capital inflows; and

— the structure and scope of the public sector.

These problems should not become barriers to continued reform towards the ultimate goal of eradicating poverty. Several participants stressed that knowledge of the economic growth process still remains far ahead of actual reform in most countries. This argues for a common effort among academics, public officials and policy makers to convince governments to carry on.

Perspectives for an Integrating World Economy: Implications for Reform and Development

Helen Hughes[1]

Dimensions of the Tasks Ahead

In the half century since World War II, the world's population has grown at an unprecedented rate, mostly in developing countries, to the present 5 billion people. For most of those living in market economies, living standards rose even more rapidly, with leading developing economies catching up to high–income industrial countries. Nutrition, housing, health and education have also improved, as increasing longevity indicates, with the proportion of the population living in absolute poverty declining everywhere except in Africa. In most developing and centrally planned economies, however, standards of living rose only very slowly, because inappropriate policies lagged far behind the growth potential created by technological advances, improving knowledge of the growth and development process and a liberalising global economy.

Population growth peaked in most developing countries in the 1980s, but the demographic characteristics built in by high past birth rates should cause the world population to double again before it reaches a "steady state" of 10 to 11 billion in about 2050. This optimistic projection assumes continuing and, in many countries, accelerating economic growth. In addition to convergence towards high living standards for existing populations, jobs, food, housing, education and health care will have to be found for those yet unborn, mainly in developing countries, without damaging the world environment. All countries face the challenge of crafting improved economic and social policies at home and internationally that will deliver higher standards of living.

The principal lesson of the last 50 years is that productive employment is the key to development. The countries which grew rapidly and could reduce poverty substantially adopted stable macroeconomic policies, modernised their agriculture and managed to move surplus, underemployed workers out of the countryside into competitive manufacturing, construction, utility and service industries.

Although the same basic, mainstream economic principles apply at all levels of economic development, each country has a unique growth path and requires unique policies at any given time. Employment creation has to take into account the existing level of development, the comparative advantage it can exploit, the necessary infrastructural and productive investment and the savings required for such investment. Education and health policies are critical components of employment creation. Much can be left to private entrepreneurs, even in the social sectors, but the externality gains, particularly for groups at low levels of per capita income, compel governments to ensure that infrastructural frameworks support growth. In the intensely political process of development, leaders must obtain the support of the majority of the population for sustainable and equitable growth.

International trade and capital flow liberalisation played a key role in the rapid growth of countries that took advantage of expanding global markets. International economic relations are freer than ever before but obstacles to trade remain, notably in developing and transitional economies. Industrial countries are backtracking and unemployment holds back further trade liberalisation. The conflicts between trade and protectionism have shifted from global to regional arenas. Markets dominate international capital flows, which have developed freely without bureaucratic intervention. Migration flows, despite their social, cultural and political difficulties, have become substantial.

The Political Economy of Development

Ideologies are important in policy formulation. Despite their failure to deliver rapidly rising living standards, protectionist policies and "development economics" (Lal, 1983; Little, 1982), albeit in new garb, continue to influence policy. "Selective" government intervention (World Bank, 1993) and "strategic" trade policies (Helpman and Krugman, 1986) support infant industry measures to pick dynamic comparative advantage "winners". "New growth theory" suggested that more advanced countries will grow more rapidly than less advanced countries, so that catching up becomes an impossible dream and development largely a matter of chance and even luck (Easterly, 1995). "Market socialism" attracts old fallacies in new guises. Better economic policies require political debates that explain the issues and expose populist demagogues. Africa demonstrates that political development is far more difficult than economic development and that without some political sophistication development stalls.

Many small and medium–sized countries do not take advantage of their political cohesiveness (which is different from homogeneity), but those that do, from Singapore to Switzerland, have the best growth records. The Czech and Slovak Republics recognised that separating politically would not impede their economic growth. Provided trade remains free, a great deal of further political fragmentation would considerably benefit living standards, satisfy cultural preferences and allow more grassroots political

democracy. In very large countries such as China, India and the United States, identical fiscal, monetary and social policies do not suit all provinces/states. Provided that trade and factor flows remain free, decentralisation speeds growth.

Nation–states form the building blocks of economic development. A country needs internal as well as external political stability and a well established rule of law so that producers and consumers can make decisions in a clearly defined and fair environment. Otherwise commercial transactions slow down and corruption flourishes. Security, law and economic and social policies determine the mores that influence productivity and efficiency, and draw out of cultural heritages the qualities essential to development. Buddhist, Confucian, Protestant, Roman Catholic and Islamic value systems and religions foster or retard growth and development according to the national policy frameworks within which they operate. High savings, for example, do not result from inherent national, ethnic or religious beliefs, as was once claimed regarding industrialisation in Europe (Weber, 1904; Tawney, 1926) and more recently for East Asian countries (Chen, 1989). The Republic of Korea did not change its culture when it transformed from a "basket case" in the 1950s to a powerhouse of growth in the 1960s. Botswana and Mauritius have attained high growth without converting to Confucian and Buddhist ethics. Latin American in culture, Chile has abandoned the counterproductive policies that continue to plague many of its neighbours.

Governments make key contributions to development. They determine, explain and monitor the direction and pace of economic progress. Political leadership in countries as diverse as Indonesia and Chile has taken advantage of rising educational levels to stress social responsibilities and raise the rationality of the development debate, making populist rhetoric less persuasive. Steady and equitable growth from year to year creates support for difficult policy choices necessitated by internal or external shocks such as harvest failures or changes in international prices. The failure of governments to lead constructive public debate on economic and social issues, however, has led to slow growth in many developing countries and to the re–emergence of unemployment in industrial countries.

The economic, social and political failures of inward–looking, statist and centrally planned economies, often leading to cruel poverty and political oppression, now lie exposed. The effective contribution that the "invisible hand" of open, liberal market economies makes to such ideals as equality, justice and social co–operation does not have the intuitive appeal of socialist ideologies. Nor have liberal writings matched the vigour of socialist polemics. The arguments for government measures to correct "market failure", to build "dynamic comparative advantage" and for "market socialism", now more *sotto voce*, persist. Inappropriate policies engendering high levels of corruption remain widespread. They explain why twice as many African countries had declining as had rising per capita incomes between 1979 and 1994 (World Bank, 1996). South Asian, Middle Eastern and Latin American countries lost years of development opportunities. Most people in the world are poor today, and a small but significant proportion of those in industrial countries face falling incomes because of weak economic and social policies.

National Policies

National government has four principal economic policy functions. First, it must maintain the economy on an even keel, with low inflation and stable exchange rates. Second, a country needs outward–oriented trade policies that will lead to the exploitation of comparative advantage and international competitiveness through high productivity. International market prices reflect real resource endowments and scarcities, and thus determine the optimum allocation and use of resources and factors of production within and between sectors. As work forces become skilled, dynamic opportunities to exploit comparative advantage develop. Third, as many infrastructural sectors, even in open economies, have public goods characteristics with externalities (costs and benefits) that cannot be captured through market prices alone, and because these sectors also have long–term investment horizons, the government has to establish regulatory regimes in social and physical infrastructural markets so that investment of appropriate quality and quantity will take place and these sectors will operate efficiently and equitably. Fourth, government must establish a "safety net" for the disadvantaged without damaging market efficiency in such areas as industrial relations. Economic and social policies must form a consistent framework. They have to evolve over time but avoid constant, arbitrary changes. Government responsibility also involves transparent, efficient and effective administration that avoids corruption and rent seeking by entrepreneurs and bureaucrats.

Macroeconomic Policies

Prudent macroeconomic management is essential for growth and development (Hughes, 1985; Fischer, 1993). Fiscal policies, taxation (Bird, 1992), the design and control of expenditures, and hence the construction of budgets, with the associated policies and policy instruments, are the keys to price stability. Without prudent fiscal policies, monetary policies become seriously constrained. The failure of many developing and industrial countries to adjust to price changes in the 1970s, and the subsequent bout of inflation which had to be brought to an end by the policies that led to the 1982–83 recession, arose from fiscal policy failures — notably in the United States, but also in most other industrial and developing countries. The East Asian market–oriented economies, countries such as Botswana, Mauritius and Malta, and more recently Chile, have been exceptions. In India, fiscal prudence from the late 1960s laid the foundations of accelerating growth, but subsidies to state enterprises undermined macroeconomic management until reforms began in the 1990s. In China, Viet Nam and many formerly centrally planned East European and Central Asian economies, "soft budget constraints" (Kornai, 1990), aggravated by the lack of separation between taxes and subsidised credit, continue to encourage inflation. "Structural adjustment" programmes have achieved little without fundamental public sector and fiscal reforms. In industrial countries, fiscal difficulties arise from falling taxes and rising welfare costs that follow from unemployment.

In developing countries, financial repression (McKinnon, 1973) — the suppression of market interest rates through public ownership and regulation of financial institutions — reduced private savings, limited the availability of investment funds and encouraged capital flight; but early reform of financial sectors improved some countries' productive efficiency. Credit rationing, inevitable with financial repression, remains highly inefficient. In the Republic of Korea, for example, the use of foreign suppliers' credits when subsidised credit allocations ran out undermined the growth of domestic capital goods industries. Credit subsidies that favoured large conglomerates inhibited the development of small and medium–sized firms, and subsequent policy efforts could not correct the distorted structure.

A combination of fiscal deficits with financial repression inevitably led to monetary instability. Inflation followed when governments borrowed excessively at home, thus crowding out private business borrowers, or borrowed abroad with ensuing external debt creation. The principal beneficiaries were the industrial countries which received flight capital from financially repressed developing countries. The banks in industrial countries turned around such savings to lend them back to developing country governments and entrepreneurs at higher interest rates. Some host governments used this money for current expenditures (consumption). Government guarantees to private entrepreneurs borrowing abroad encouraged profligate investment in highly protected industries. Debtors like Argentina, Brazil, the Philippines and Mexico, which caused the most debt concern in the 1980s (Avramovic, 1985), had more funds deposited by their nationals in industrial countries than they owed in private and public borrowing. Similar trends appear today in Russia and other states of the former Soviet Union.

Financial constraints and overvalued exchange rates harm manufacturing (Asian Development Bank, 1971; Balassa and Associates, 1971; Little, Scitovsky and Scott, 1970). Inappropriate macroeconomic policies also have major effects in distorting price signals to agriculture (Krueger, Schiff and Valdéz, 1988), reducing output levels, productivity and incomes in the countryside. Avoiding inflation, and bringing it under control quickly if it occurs, have been important policies in reducing poverty and improving income distribution in East Asia (Bautista, 1992; Krongkaew, 1994). In Latin America, Africa and more recently some of the economies in transition, inflation persists as a major cause of worsening income distribution.

With the end of financial repression and free capital flows, government responsibilities should become mainly prudential. Regulators have to learn to exploit the technological advances leading to the improvement in the availability (speed and scope) of information to ensure that financial markets operate competitively and efficiently. Banking, pensions, life and other insurance, stock exchanges and standards of corporate governance have now come under public review. In the past regulations often encouraged "moral hazard". Central banks allowed the assumption that they would rescue commercial as well as publicly owned banks in difficulties. Prudential rules for new capital market instruments lagged, permitting the exploitation of capital markets by criminals.

Trade and Competitiveness

The opening of world trade in manufactures after World War II gave a tremendous advantage to the principal participants (West European and North American industrial countries and Japan), but access to their markets also played a critical role in the rapid growth of the East Asian "Seven" — Indonesia, Hong Kong, the Republic of Korea, Malaysia, Singapore, Chinese Taipei and Thailand (Hughes, 1995). These economies dominated developing country exports of clothing, footwear, textiles, electrical and electronic products, toys, artificial flowers, sporting goods and other labour–intensive manufactures. In the 1980s, exports of labour–intensive goods from developing countries began to widen (Havrilishin and Alikhani, 1982), but inappropriate policies continued to constrain exports from many countries.

Hong Kong and Singapore based their export orientation on open trading. Chinese Taipei and the Republic of Korea, however, found trade and financial policy reforms infeasible politically, notwithstanding the successful introduction of fiscal and monetary policy reforms at the end of the 1950s. Both countries therefore attempted to offset import–substitution policies by so–called export incentives. The only successful measures took the form of exemptions from quantitative restrictions and tariffs on goods needed as inputs into exports (Herderschee, 1991). Other "incentives", i.e. subsidies such as privileged access to domestic markets, tax holidays and subsidised credits, had high costs and delayed trade policy reform. The continuation of import substitution and export subsidies necessitated detailed, direct government intervention to prevent the market distortions created by import–substituting and financially repressive government policies from undermining development. Accounts claiming that "picking winners" worked neglected the costs of intervention (Amsden, 1979, 1989; Bhattacharya and Linn, 1988; Wade, 1990; World Bank, 1993). Standards of living would have risen faster, environmental concerns could have emerged earlier and corruption could have been greatly reduced if public revenues had not been wasted to offset protection.

The more controls, the larger the staff needed to service them (Messerlin, 1981). Worldwide experience suggests that direct intervention in the economy generally leads to some measure of corruption. For bureaucrats such intervention means jobs, the expansion of their fiefdoms and often benefits in the shape of directorships and other jobs on retirement. Politicians use subsidies to buy votes, directly from entrepreneurs and indirectly from their workers, families and friends. Intervention serves as an invitation to corruption in industrial, transitional and developing economies alike. Fortunately, the exposure of the linkage of controls to personal and political corruption has begun to emerge publicly.

Chinese Taipei and the Republic of Korea offset the import–substitution bias against agriculture with fertiliser and other subsidies and by complex public rice–purchasing schemes. They organised farmers into co–operatives that became highly protectionist (Anderson and Hyami, 1986; Anderson, 1994). As agricultural productivity increased, surplus labour moved out of agriculture into rural industries

and the rest of the economy. Tourist, financial and other services developed (Hong, 1981; Kim, 1991; Kuo, 1983; Li and Yu, 1982; Ranis, 1995; Riedel, 1988). Malaysia, Thailand and Indonesia had good resource endowments, were less protectionist, benefited from smuggling and liberalised at a relatively early stage of development. Chile, and more recently India, have followed. The depth of reform in other developing countries, notably in Latin America, China and Viet Nam, has yet to become clear.

In many developing countries, public ownership "of the means of production" accompanied import substitution to prevent national and transnational monopolies from taking over "the commanding heights of the economy". Public ownership of industry, with such attendant inefficiencies as vast overmanning, has also seen wide use in Europe to save politically favoured enterprises from bankruptcy (a harsh, but fair and efficient, market response to inefficiency). Many industrial as well as developing country governments thus now own rusting, obsolete productive capacities and employ workers with out–of–date skills, on the grounds that this prevents the waste of manpower and investment! It is not surprising that privatisation has proved to be difficult.

Infrastructure

The differences between human and physical assets per capita are much greater than per capita income differences between high– and low–income countries. Their public goods aspects make infrastructural policies much more complex than those that can operate simply through market prices. Combined with population pressures and hence the need for rapid urbanisation, investment in, and the efficient operation of, social and physical infrastructure are essential aspects of development. Poor and slowly growing countries have the greatest infrastructural problems, but these problems are also evident in some rapidly growing developing countries and even in industrial countries.

Paradoxically, the worst infrastructural shortcomings have emerged in centrally planned and "mixed" economies which claimed to be socially oriented. Despite high savings in countries such as China, India and the former Soviet Union, the priorities given to "heavy" industries such as steel and engineering, and to defence, distorted investment. Operational efficiency fell so low that these countries could not meet the demand for transportation, health and housing. Market–oriented economies that place a high value on productivity, efficiency and international competitiveness have had much more success in meeting productive needs and consumer demand.

Infrastructural policy has to recognise the uniqueness and limited availability of land, particularly for urban uses. Land development under less than socially efficient and transparent conditions leads to large profits for developers. It is often associated with corruption. The role of local, provincial and central government in urban development faces particular difficulties, yet housing plays a very important part in

health, education and general well–being. Private and public infrastructural requirements have to be balanced, for example, in the ownership of motor cars and public transport, in health and in education. Where externalities exist, markets need regulation. Fortunately, technological advances reduce areas of "natural monopoly" which require the most controls. Openness and transparency in decision making are necessary safeguards in infrastructure development against misallocation of investment and the monopolistic exploitation of consumers. Given an appropriate regulatory framework, competing private firms likely will supply infrastructural facilities more efficiently than public monopolies. Technological changes have made deregulation possible in transport (competition between road, rail, sea and air), telecommunications (where multiple providers of telephone and television services have become economically viable) and power production. Several firms can supply stevedoring services in ports. International comparisons can now provide benchmarks for regulators.

Environmental outcomes have gained recognition as an important component of infrastructural efficiency, partly because of their close association with outputs such as drinking water and transport modes, but also because desirable outcomes have external benefits and costs. Much environmental clean–up can come from building into the cost of production and hence into market prices the costs of clean air and water, replanted forests and clean fuel technologies, but in some cases this is not possible and regulation becomes necessary to achieve social objectives. While ultimate environmental objectives are universal, developing countries' constrained resources must be expected to cause their environmental priorities to differ from those of high–income countries. Recognising such differences reduces international tensions.

Innovative investment approaches have broken through infrastructural logjams. Countries seek foreign investment to "build, operate and transfer" power stations, telecommunications, ports and roads; investors from industrial countries and some more advanced developing countries build turnkey projects, which they own and operate for a predetermined period, under agreed pricing and profitability arrangements, before turning them over to local producers. It clearly will take some time to sort out how such projects may be funded and operated effectively. National regulatory frameworks within which such investments can operate are being established. Regulatory problems do not affect only developing countries. In telecommunications, for example, the failure to adopt appropriate regulatory environments is also holding up investment in industrial countries.

While foreign investors may be able to contribute capital and technology (in both engineering and infrastructural sector management, including pricing and regulation) to improve overall productive capacity, except in very small countries, capital inflows can play only a marginal role in the "catch up" of infrastructural investment. They contribute only 5 to 10 per cent of total investment in rapidly growing developing economies. Where they contribute 50 per cent or more (sometimes more than 100 per cent because part of the capital inflow is spent on consumption) the economies are stagnating. Infrastructural development thus links closely with

macroeconomic policies, involving high saving rates of well over 30 per cent, the ability to transform savings into efficient private and public investment, and the efficient operation of the resulting facilities.

Welfare

In traditional societies, family and clan look after those too young, too old, or too disabled to work. In practice, looking after the disadvantaged falls on the poorest members of society. Most of the physical and emotional burdens are borne by women "carers" who receive little recompense or recognition. Acknowledgement of their social role as countries' per capita incomes grow has been a great social advance, but implementation now poses new challenges in developing, transitional and industrial countries.

Social "wages" have two sources. Some social security arrangements, such as health services, pensions and severance pay, evolved with industrial employment. Over time such payments became delinked from productivity and, together with protective practices such as "seniority" in promotion and firing, led to wage inflexibility and raised labour costs while often depressing earnings levels, particularly for highly productive workers. Production became uncompetitive internationally and overall employment fell. After some 25 years of full employment after World War II, unemployment re–emerged in industrial countries in the 1970s and now totals almost 34 million people. Only a handful of industrial countries including Japan, Switzerland and Norway, and the "four tigers" have less than 5 per cent unemployment. In the United States and New Zealand, unemployment is between 6 and 8 per cent. In most industrial countries it lies between 8 and 12 per cent, but in Finland, Spain and Ireland it is even higher (OECD, 1996). Youth unemployment generally runs at twice the level of adult unemployment.

In most industrial countries, a second stream of social security took the form of population–wide unemployment, old age, sickness and disability and other benefits. During the rapid growth of the 1950s and 1960s, this "safety net" concept extended greatly. With education expenditures included, middle–income families benefit much more than low–income earners and the unemployed. Education expenditures, moreover, often do not support employability for young people from low–income families (Schmid, Fuglistaler and Hohl, 1993).

Social security payments, intended to keep the unemployed out of poverty, catch many men and women in a "poverty trap", better off not working than taking low–paid jobs. Unemployed workers face sharp reductions in living standards even when unemployment benefits reflect past levels of remuneration. They become traumatised by unemployment, suffer illness and family break–up (Feather, 1990; Fryer and Payne, 1986) and rely increasingly on welfare benefits. They are "cared for" by an army of social workers. Not surprisingly, they become "welfare–dependent". After a period of unemployment, workers' skills become eroded. They find it difficult to

make the effort to look for jobs or to take on work deemed unpleasant in the community. This applies particularly to middle–aged workers, often the victims of poor management practices that for years failed to provide them with on–the–job training. Formerly centrally planned economies have extremely heavy costs of this type. In the United States, where welfare is extremely limited, unemployment has been kept relatively low, but a new group of uneducated and unskilled "working poor" cannot afford to live decently on wages that reflect their very low productivity.

Many enterprises avoid the high fixed costs of full–time employment by increasing casual and part–time work. This is efficient in some situations but not in others. Women, who represent 75 per cent of part–time workers in industrial countries, often cannot find full–time jobs. In part–time jobs they cannot develop career paths to become supervisors and managers. Young workers work part–time while they are studying, but many do so because there are no full–time jobs. Unemployment raises social security costs even as it reduces output and taxes, creating fiscal problems.

Developing countries have introduced welfare payments and wage inflexibility into the formal workplace, particularly in state–owned enterprises, limiting employment opportunities severely for those outside the favoured sectors. Low income levels have capped general welfare payments in most developing countries, but the more advanced among them now face up to welfare policy issues because they do not want to repeat the mistakes of the industrial countries.

Inappropriate wage structures and welfare systems contribute markedly to the difficulties of adjusting to changing technology and global shifts in comparative advantage. "Band–Aid" measures are used to keep electorates, including not only the unemployed but also their relatives and friends, anaesthetised. Labour market programmes, mainly for training but also including employer subsidies to hire the long–term unemployed, flourish to the great advantage of bureaucrats administering these schemes and a new industry of "trainers". Despite overwhelming evidence that such schemes are not cost–effective, they continue to be endorsed (OECD, 1988, 1990, 1994*a* and *b*). The analytical basis for reforms is clear (Bean, 1994; Layard, Nickell and Jackman, 1991, 1994; Lindbeck and Snower, 1989; Snower, 1994), but politically unpalatable.

Pressures from employed "insiders" make it very difficult to reform the structure of wages and the welfare system in industrial countries to increase productivity and efficiency while retaining a humane safety net. The personal and national costs of growing numbers of "outsiders" are not made clear. To enable industrial economies to adjust, enterprise bargaining will have to replace nation–wide remuneration settlements, to link remuneration with productivity and make labour markets more flexible. The present intrusive social security systems need reform; negative income taxes offer one solution. If the industrial countries and the transitional economies seeking to adapt to market conditions do not introduce major new labour market and welfare system initiatives, their international uncompetitiveness will worsen. Unemployment and fiscal deficits will continue to rise, with the socially and politically disruptive effects of high unemployment not far behind.

Demographic trends underline the urgency of policy change. Most countries face greater dependency ratios as schooling for young people is prolonged, often until they are in their twenties, to fit them for the technologies of the 21st century. Singapore plans to have 60 per cent of school leavers graduate from universities or polytechnics from the year 2000. Ageing and longer–lived populations can be productive much longer than the traditional retiring ages of 55 to 65 (although not necessarily in the jobs in which they have been working), but when they reach their eighties and nineties they require substantial medical services. The labour force must become highly flexible. Workers will move within and among countries. Jobs will not be for life. Changes in technology and world trade close some employment opportunities as they open up others, so that workers need a strong educational base for lifetime training. All these changes have far–reaching implications for education, training, labour remuneration and welfare.

The International Economy

Trade, capital, labour and technology flows interact in both complementary and competitive ways. Goods and services can be traded, investment in production abroad can substitute for trade, labour can move and technology finds embodiment in goods and services, capital or labour. Such movements occur within countries, particularly large ones, as they develop. Regional arrangements seek to emulate "large country" conditions, trading off the loss of national sovereignty against the gains from unimpeded international economic relations.

Trade in Goods and Services

Between the two world wars, highly protectionist regimes contributed substantially to the misery of unemployment and depression in the 1920s and 1930s, and ultimately to World War II. Post–war leaders saw free trade as essential to building the prosperous and just world for which World War II had been fought. Yet the political economy of trade is asymmetrical. Those who have investments and jobs often see free trade as a threat that will take away their livelihoods. They are well organised. Those who would benefit from new investment and job opportunities do not perceive the advantages that open trade will bring. Negotiation of the international reduction of protection, including non–tariff as well as tariff barriers, therefore developed within the GATT framework, using reciprocal access to national markets to persuade those resisting liberalisation to negotiate reductions in trade barriers, and making such concessions available to all under the most favoured nation (MFN) principle. The initial multilateral negotiations — the Dillon and Kennedy Rounds — devoted to reducing quantitative restrictions and tariffs, mainly on manufactured goods, proceeded with relative ease. The Tokyo Round had remarkable success in determining a Code of Conduct on non–border protection, but GATT was too weak to implement it. The Uruguay Round negotiated agricultural products, services and more non–border issues. Its fruitful outcome and ongoing negotiations will take a decade to implement.

GATT and its successor, the WTO, inevitably reflect the political and ideological pressures of their times. As colonial countries won independence, the recognition of the ills of metropolitan–colonial relationships led to a determination to right past wrongs. On the strength of Singer–Prebisch arguments, GATT articles XXXVI to XXXVIII exempted developing countries from trade liberalisation obligations. Their non–tariff trade barriers multiplied and tariffs went up, crippling most of them. Reform strategists could not use the "reciprocity" argument to persuade domestic producers to give up protection in return for access to foreign markets. By not taking part in multilateral negotiations until the Uruguay Round, many developing countries also missed opportunities to improve their access to markets of particular interest to them. Assertions that "dependence" on international trade is a remnant of colonialism proved increasingly foolish as the East Asian countries the most exposed to international trade grew most rapidly, and inward–oriented economies felt external shocks more than open–market ones.

To avoid adjustment to international trade in labour–intensive production, industrial countries imposed import quotas, administered by developing countries through "voluntary export restraints". GATT acquiesced. Most voluntary export restraints disappeared under the pressure of competition, but persisted in clothing and textiles where GATT actively supported the system (Hamilton, 1989). Only the Uruguay Round finally set reform of the system in motion.

The UN, mainly through UNCTAD and again following the Singer–Prebisch "development economics" view of trade, came up with a scheme to help developing countries that ran counter to the MFN principle, fragmented developing country access to industrial country markets and undermined trade liberalisation. Developing countries received preferential access to industrial country markets for manufactures under Generalised Schemes of Preferences (GSP). Industrial countries extended quotas for "sensitive" products to take account of the operation of preferences. "Exclusion" and "inclusion" lists flourished by product and country of origin and destination. They changed frequently, becoming a bureaucrats' paradise but a business nightmare. European, Japanese and US quotas for particular products and countries often ran out within weeks of the opening of a quota year. Exporters who wanted to take advantage of preferences had to store goods in bonded warehouses in the country of destination. The competitive ones soon found that this was costlier than foregoing the preferences. The preference schemes had a negligible positive impact (Langhammer and Sapir, 1987; Toh and Low, 1991). As tariffs declined, some developing countries became persuaded that further trade liberalisation went against their interest because it would reduce their preferential margins! The WTO has nevertheless recently proposed a new variant of this scheme (*Financial Times*, 9 July 1996).

The WTO has a very considerable task to maintain the trade liberalisation impetus in the face of widespread national and regional avoidance and evasion of existing rules. The addition to its agenda of non–trade issues like the conduct of private direct foreign investment, product standards, determination of "fair" wages and environmental standards tempts it to avoid its central responsibility. Diluting its trade focus weakens its professionalism and influence.

Capital Flows

Markets have led and implemented capital flow liberalisation. Despite energetic bureaucratic efforts, international "rules of the game" for capital movements have been avoided. The Bank for International Settlements helped leading central banks to set up widely followed national prudential standards. The openness and efficiency of international capital markets have shifted technology flows from trade (royalties, licences and similar fees) to their incorporation in capital flows, mainly in the form of private direct foreign investment.

The United States unwittingly helped the growth of international capital flows by trying to impose limitations on the export of capital. A tax on foreign securities issued in US markets led to the establishment of the Eurodollar market in the mid–1960s. IMF support for fixed exchange rates inhibited capital flows because of the risks of large devaluations, but exchange rates became more flexible in the 1970s, although the EEC managed to keep intra–EEC rates within narrow margins until the sterling crisis of 1977. The freeing of exchange rates and the spurt of liquidity from petroleum price increases further stimulated international capital flows. Technological advances lowered the cost of arbitrage substantially. New capital markets in new time zones (in Tokyo, Hong Kong and Singapore) increased the competitiveness of international banking, although some industrial as well as developing countries failed to benefit because of domestic capital controls until the 1980s and 1990s. Many developing countries' policies still constrain capital movements.

International "safety net" proposals to introduce "moral hazard" constraints into international financial markets did not come to fruition. The principal financial failures of the last 50 years have resulted from failures of national financial policies in industrial countries. Taxpayers picked up the costs. Neither international capital flows nor private sector borrowing from international capital markets created the so–called "debt crisis" of the early 1980s, which stemmed from excessive government borrowing (arising from domestic fiscal, financial and monetary policy failures) and from government guarantees of external private sector borrowing. No international financial crisis would have occurred if the market had been allowed to operate, although some heavily exposed banks might, appropriately, have gone bankrupt. Total lending to developing and centrally planned countries amounted to less than 10 per cent of total lending by industrial country banks, and not all of that lending was at risk; the international capital market as a whole was not threatened. Countries such as Thailand and the Republic of Korea repaid all their private and public debts, subsidising imprudent lenders and borrowers whose debt was "restructured". "Socialising" developing and centrally planned economy debt shifted the burden from those who borrowed and lent wantonly to taxpayers in industrial and developing countries.

The speed and range of capital market operations and new financial instruments, notably futures, options and other derivatives, have increased the complexity of managing financial institutions. Most of the time, the markets perform extremely well, but some company directors still think managing financial institutions requires little exertion beyond eating good lunches, and some financial institutions fail.

Private Foreign Direct Investment (FDI)

Private direct investment has grown remarkably. Traditionally, FDI took place in raw materials with high resource rents and in import–substitution ventures that provided high monopoly rents for "defensive" foreign investment in protected industries (Hymer, 1976). As non–tariff and tariff barriers fell, transnationals searched the world for low–cost production sites for world markets. Socio–economic returns to host and home countries grew.

Ideological fears of private FDI have engendered a very considerable research effort. It has thus become well established that policies in host countries principally determine the level and direction of private FDI flows and their socio–economic impact on host and home countries. Neglecting the research findings, the fashion has swung to excessive claims for the benefits of FDI to host countries. The transitional economies, as well as many developing countries, now seek foreign investment side–by–side with industrial countries, the main sources and recipients. Governments use tax holidays and other wasteful incentives (subsidies) competitively, although such incentives likely do not have a major influence on FDI flows (Guisinger and Associates, 1985). Some countries still attempt to impose "performance criteria" on transnational corporations, in the transfer of technology, contribution to exports, training of local staff and so on. To the extent that such objectives conform with the price signals a country gives to all firms, they are redundant; to the extent that they attempt to offset existing counterproductive price signals, they are ineffectual. Acrimony inevitably follows. The Republic of Korea and India eschewed private FDI into their protected markets on the grounds that the socio–economic costs would exceed the benefits. Deep trade liberalisation is in fact essential for the benefits of FDI to exceed the costs.

Private FDI flows continue to increase as the world economy expands, trade liberalisation proceeds, the returns to technological innovation rise and a professional labour market develops. After initial domination by US investors, European and other (even small) industrial countries have also become home to transnationals, as have Japan and the rapidly growing East Asian developing countries. Other developing countries follow as their economies are reformed. The diversification of ownership has helped to reduce both the fear and the possibility of undue home–country influence, further stimulating the growth of private FDI. Distinctions between intracompany flows, bond issues and equity investment are becoming blurred. The United States has made a substantial contribution to reducing wasteful competition for foreign investment by not practising tax sparing. When profits on which tax has not been paid because of tax holidays or similar benefits are repatriated to the United States, tax has to be paid on the component granted a tax holiday in another country. More would be achieved by following its lead than by pursuing the fruitless attempts over 30 years to establish international rules for private FDI.

Regionalism

Regional economic arrangements are justified by economies of specialisation, scale and diversification that can be generated by expanding markets in an otherwise protectionist world — but they have little justification in a generally open trading environment. To the extent that they build half–way houses, not opening economies fully to free trade, they lead to trade diversion and hence to costs (to the countries concerned and global trade) which may well exceed the benefits from trade creation (Meade, 1955; Viner, 1950). Potential economic gains, however, do not offer the only and often even the principal motivations for regional trade arrangements, which have a long political history in Europe as an instrument for the formation of nation–states. Political motivation largely drove creation of the EEC. The formation of ASEAN was a political reaction to the threat of communist aggression in East Asia. Protectionism is a third motivation.

Import–substituting Regionalism

The high costs of import substitution strategies soon became evident even in large countries such as Brazil and the then relatively high–income ones such as Argentina, in the Latin American heartland of Singer–Prebisch ideologies. Prebisch argued that the economic costs of import substitution did not follow from faulty theoretical constructs but resulted from the smallness of developing country markets. Regional import substitution — protectionist customs unions — gave the answer (Prebisch, 1959). The argument was taken up by ECLA, in ECAFE (which became ESCAP), in the fledgling ECA, in the Development Planning Committee of the Economic and Social Council of the United Nations and, very vigorously, by UNCTAD. The rapid growth of the founding "six" of the EEC (Belgium, France, Germany, Italy, Luxembourg and the Netherlands), part of the wider European growth that followed the multilateral reduction of protection, was misrepresented as following from the EEC arrangements. GATT failed to defend global free trade, accepting more than 100 regional arrangements that contravened its Article XXIV, which permits only regional arrangements that do not discriminate against non–members.

Import substitution arguments led to the establishment of regional agreements in Latin America, Africa and the Middle East. The islands of the Caribbean formed the Caribbean Free Trade Association, later transformed, on paper, into the Caribbean Common Market. Islands which had difficulty organising export–oriented shirt factories began to dream of iron and steel plants. The Andean Common Market was born. France supported plans for common markets in Central and Western Africa, with a common, overvalued currency tied to the French franc as the glue that held these arrangements together. The East African Community had a brief resurgence after independence from Britain but then fell apart. Considerable, totally wasted efforts went into common external tariff arrangements, regional investment and

"complementation" negotiations. The principal effect was to raise tariffs in each region to the highest common denominator (Balassa and Stoutsjedijk, 1976; El Agraa, 1994; Vaitsos, 1978).

The greater these agreements' apparent short–term success, the higher the costs to the constituent countries. The main beneficiaries of the Latin American Free Trade Area, for a time a fairly successful regional trade arrangement, were the oligopolistic transnational corporations that could expand their components markets regionally, reducing unit costs but maintaining costs and prices above international levels. Their exports were much less labour–intensive than those resulting from the independent national policies of the East Asian "Seven" (Krueger, 1983).

The most "successful" regional arrangement, the Central American Common Market embracing Nicaragua, Costa Rica, Guatemala, El Salvador and Honduras, was also the costliest. Trade diversion dominated over trade creation. Costa Rica's exports of clothing to the United States became uneconomic. Import substitution imposed high costs on agriculture and other sectors. A small group of entrepreneurs and factory workers in the "formal sector" benefited at the expense of the majority of the population (Wilmore, 1976). The Market contributed to the political instability of the region.

EEC–EU trade diversion costs have been considerable. The Common Agricultural Policy has harmed consumers and taxpayers as well as outside producers. Farmers in developing countries, who can least afford it, bear the brunt of the costs. Spill–over effects of such EU–managed trade diversion as cassava chip feed imports have damaged Thai and Brazilian cassava producers and processors. The EEC–EU has much higher protection against sensitive labour–intensive products than the United States and other industrial countries (Langhammer, 1986). The take–over of "sensitive product" restrictions by Brussels from national governments reduced developing country access to these markets. Importers into the EU face many non–tariff barriers. Trade preferences to the Lomé and Maghreb countries perpetuate colonial "divide and rule" relationships. The EU remains extremely restrictive in its trade with neighbouring central European countries, using "aid diplomacy" — small flows of aid — to limit protest.

The new spurt of regionalism outside Europe, including the creation of arrangements that include industrial and industrialising countries, in part reflects political objectives, notably those arising from the break–up of the anti–Communist alliances, but it also has strongly protectionist motives, often presented as fear of EU protectionism. The United States–Israel Free Trade Agreement was clearly political. Trade negotiations between Canada and the United States go back to at least 1911 with a changing agenda of political, cultural and economic issues. The 1988 Canada–United States Free Trade Area thus became a step in a long process. It had some bonuses for free traders because it might lead to trade creation and some for protectionists because it contained immediate trade diversion steps. The politically induced NAFTA that sought to support the Mexican economy and thus limit Mexican

migration to the United States swamped its effects. NAFTA clearly discriminates, notably against East Asian producers. Some shifts in the sourcing of footwear and other labour–intensive products have already occurred from East Asia to Mexico.

Fortress Regionalism

No body of theory supports the extension of free trade policies to macroeconomic, microeconomic and social policies. The costs of a single monetary policy for countries at different levels of development and with differing degrees of success in economic management likely would overwhelm, as is increasingly evident, the benefits of a common monetary discipline to help member countries to internal (budget) and external (current account) balance.

Political and economic policies have become mixed up. Counterproductive economic policies are marketed as the price of peace in Europe, with support for the European Monetary Union (EMU) as the litmus test of political support for it. Political irresponsibility, born of the inability or unwillingness to take on the "insider" lobbies, supports an EMU although fiscal, financial and monetary policies would cease to be national policy instruments. The great advantages of a number of national authorities seeking to manage fiscal policies well, and hence having room to manoeuvre to achieve low inflation and high employment, would be given up for the convenience of not having to explain economic issues to voters. The costs of establishing a European Central Bank and a uniform currency as the world's primary reserve currency (because, it is argued, an enlarged Europe will be larger than the United States) have been ignored.

The perception that "fortress Europe" threatens increasingly protectionist and discriminatory measures against outsiders has led other West European countries (except Switzerland) to seek EU membership. For Central European transitional countries, the political threat of a potential re–emergence of Russian attempts at hegemony reinforces the desire to become part of a West European community.

Inward–oriented regional arrangements are difficult to reform because the influence of voters on policies is tenuous. Power passes to the bureaucracy, as the EU has made evident. Not only are operating costs egregiously high, but democratic processes are subverted.

Open Regionalism

The ASEAN countries also flirted with regional investment and "complementation" schemes, but business opposition led to their abandonment. They have deliberately confined preferential trade arrangements to goods in which trade is minimal to avoid problems of origin, yet intra–regional trade has grown faster (together with total trade) than in other regions. The ASEAN Free Trade Arrangement is a

reaction to European and North American regionalism. It causes considerable concern because of likely trade diversion costs (Langhammer, 1991). The hope is to draw its teeth by making any tariff reductions generally available under the MFN principle.

The formation of an Asia–Pacific Economic Co–operation organisation (APEC) had long been proposed by Japan. Government, business and academic groups, fascinated by and envious of the EEC, had tried to put a regional arrangement together since the 1960s. When Australia proposed the formation of an East Asian grouping to include ASEAN and the East Asian countries, the United States, with Canada in tow, insisted on membership, creating a hybrid organisation that stretches from Thailand to Newfoundland, south to Australia, New Zealand, the Pacific islands and potentially to Argentina. APEC, however, is not in any sense an economic or political "region". Its main contribution to international trade and political debates was to include the "three Chinas" — China, Chinese Taipei and Hong Kong (until 1997) — and the Democratic People's Republic of Korea in emerging East Asian dialogues.

At the first summit meeting of APEC leaders in Seattle in 1993, some US interests indicated that they would like to see the world divided into three blocs. The EU's field of influence would be Eastern Europe, the Middle East and Africa, and the United States would have a field of influence not only throughout the Americas, but also in the third, highly prosperous and rapidly growing, Asian bloc. APEC would become a discriminatory trading area like NAFTA and the EU (APEC Eminent Persons Group, 1993). How the United States, Canada and Mexico could simultaneously be members of two mutually exclusive discriminatory blocs was not resolved. The ASEAN countries led the other Asian constituents to reject this approach, opting to remain a "club" where many issues could be discussed but common action would not be taken. Thus far, for political reasons, APEC has not tackled discrimination by NAFTA against East Asian countries. The ASEAN countries showed their determination not to be separated from European markets by joining with China and the Republic of Korea to meet with EU leaders in Bangkok in February 1996. A leaders' meeting every two years is proposed. This leaves a space for meetings of the APEC group (with the United States) in alternate years. Opening relations with South Asia began with the invitation to India to participate in the ASEAN Regional Forum in July 1996.

Regionalism strengthened during the Uruguay Round negotiations from 1986 to 1994. In the several near breakdowns of the negotiations the principal culprits disingenuously argued that the Uruguay Round was unlikely to be successful. They pictured regional arrangements as steps towards global trade liberalisation even as they introduced new discriminatory measures. Political forces will no doubt continue to encourage regional groupings. The end of the Cold War; the economic nationalism of China; the confused stance of the EU, the United States and Japan on many trade issues; and the potential revival of Russia and the CIS states in the longer run all will continue to stimulate defensive developing country groupings such as ASEAN. For politicians, regional groupings provide an opportunity to appear on domestic television screens as international leaders. The less efficient and effective a government's domestic policies, the more are its leaders likely to run away from unemployment, balance–of–

payments difficulties and infrastructure breakdowns, to perform on a regional stage. For bureaucrats, regional groupings open a new source of rents. Initially, travel and fine hotels furnish the main attraction, but if they manage to persuade their political masters to create permanent secretariats, new jobs at inflated salaries with the privileges accruing to international public servants become theirs. For academic and other consultants regional groupings have been a bonanza. These vested–interest groups will ensure that regionalism, despite its costs, will not wither away.

The ASEAN countries understand that the extension of regional protectionism must be prevented to retain and enhance the liberal global environment. Market–oriented East Asian countries know that global liberalisation has brought them great benefits. They therefore opt for "open regionalism" — a club arrangement in which international economic and other relations can be explored without bureaucratic structures.

The ASEAN countries in general, and Singapore in particular, clearly make the implementation of the Uruguay Round and the completion of the negotiations begun under it their main priority. This was evident at the April 1996 "preparatory" WTO forum which sought a wide variety of views on the direction of trade liberalisation but which deliberately avoided any notion that this was a meeting that would dictate the agenda for the first WTO meeting held in Singapore in December 1996. The agenda and conduct of that meeting were the responsibility of the WTO. If other regional interest groups followed similar global policies, with regional and sub–regional "clubs" meeting periodically to discuss issues of mutual interest, globalisation would progress. Even if this does not happen, the East Asian countries will benefit from the openness they maintain, reaching out to both European and North American leaders, pursuing the development process and trading wherever the prices are right. They are thus likely to continue to grow more rapidly than other countries.

International Co–ordination

The most basic lesson of economic history is that the future is unknowable. Uncertainty, and hence risk, are unavoidable. The denial of this fundamental truth provides a major reason why central planning and "development economics" have failed so spectacularly. Bureaucrats in centrally planned and highly regulated economies increase uncertainty, risk and waste. Markets are less wasteful than planners, because they offset risks by cancelling out mistakes. This is also why unco–ordinated international policies are less costly than co–ordinated ones. Changes in weather, new technology, political upheavals and other stochastic phenomena cannot be foretold. If bureaucrats in various countries make mistakes in assessing likely future scenarios and hence in the policies they adopt, many of the mistakes will be offset. The timing of cyclical swings will not be the same in all countries and their cumulative effects will be much smaller than if major countries move together.

The dangers of macroeconomic co–ordination were illustrated at the end of the 1960s when the OECD, the IMF, the World Bank and the Bank for International Settlements all advised the industrial countries that the minor recession becoming evident would become a depression unless they undertook concerted fiscal expansion. The advice was taken. It led to the commodity boom of the early 1970s and the spectacular rise, followed by equally spectacular falls, in petroleum prices. The turbulent 1970s resulted in such high inflation that deflationary policies had to be used to return to stable prices.

The Outlook

Each country has a different starting point. Each makes its own development choices. If China and India had followed mainstream economic policies in the 1950s and 1960s, today's principal concentrations of poverty would not exist. Latin American and Middle Eastern countries would have caught up with industrial countries' living standards. Poverty would be in retreat in Africa. Equally, the economic policy choices made today will determine the living standards of children yet unborn. The pace of policy reform will have to accelerate markedly to realise the opportunities for job creation, rising productivity and rising living standards. The growth and development that would bring a decent standard of living to the ten to eleven billion people who will be alive in 50 years' time are not in sight. In many industrial, no less than in developing and transitional economies, political weakness propped up by failed, outdated ideologies endangers the well–being of today's and future generations.

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Technological Change, Globalisation of Production and the Role of Multinationals

Charles Oman

Introduction

Many have written about the impact of technological change, notably that of the microprocessor and the new microelectronics–based information and communications technologies, and their contribution to "globalisation". This paper argues that while it makes sense to speak about a globalisation of competition and of many corporate functions including investment, finance, networking and the management of corporate systems, it is wrong to speak of a globalisation of production *stricto sensu*. Production, insofar as it becomes more international (in the sense of more cross–border flows of intermediate goods and services), internationalises much more *within* each of the major regions — Asia, the Americas, greater Europe (including Central and Eastern Europe and perhaps North Africa) — than between regions. It makes more sense, in other words, to speak of a *regionalisation* of production than a globalisation of production.

Production is regionalising more than it is globalising partly because relatively large and volatile exchange rate fluctuations among the major currencies have led globally active firms to seek to match revenues and outlays more closely within each of the major currency areas, and thus to produce within each of the major regions. Another reason involves the growing importance of *proximity* between firms and their customers ("global localisation") as well as between firms and their suppliers under the new "lean" or flexible, post–taylorist approaches to organising production.

The relocation of production for consumers in high–wage countries to low–wage sites in developing countries is *decelerating*, not accelerating, certainly as regards the relocation of production outside the region of the intended market (Oman, 1994). This runs counter to popular perceptions of "globalisation" in many countries. The trend decline in the share of variable low–skilled labour costs in firms' total operating costs — crudely estimated to have fallen from an average of around 20 per cent in the

mid–1970s to between 5 and 10 per cent by the late 1980s[1] — also tends to weaken developing countries' ability to attract export–platform investment by OECD–based multinationals. Compared to the 1970s, multinationals' investment in developing countries has become increasingly market–driven as opposed to cost–driven — although compared to the 1960s, the relevant market is more regional than national. All these phenomena illustrate that globalisation and regionalisation today tend to be mutually reinforcing. One of the challenges for policy makers is to ensure that regionalisation policies in fact promote globalisation, an outcome far from automatic.

Globalisation and Regionalisation

Many use the term "globalisation" but few define it. This paper considers it as the growth, or more precisely the accelerated growth, of economic activity that spans national and regional political boundaries. "Regionalisation" involves the movement of two or more economies — two or more societies — towards greater integration with one another; it can evolve under *de jure* agreements between governments to enhance the process, or it can be a *de facto* process. Defined in such generic terms, globalisation is not new. The last 100 years alone have witnessed three major periods, or waves, of globalisation. We live in the midst of one today, since the late 1970s and early 1980s.

The previous wave of globalisation occurred in the 1950s and 1960s. Then, as now, barriers to international trade fell significantly, trade grew rapidly, and international investment, led by the phenomenal proliferation and growth of US multinationals, grew significantly faster than trade. That wave tapered off in the 1970s, when productivity growth slowed markedly in the leading economies and stagflation emerged in the latter half of the decade in the United States and Europe.

Prior to mid–century, the 50 years or so which ended in World War I also had witnessed a big wave of globalisation. Again, as now, trade grew rapidly, and the size of international and inter–continental investment, mainly financial flows, was as great or greater relative to output as today. That wave of globalisation ended in the war and the beggar–thy–neighbour policies that led to the collapse of globalisation and the economic disasters of the 1920s and 1930s — which in turn led to World War II.

What, then, is so special about globalisation today? What, in policy terms, distinguishes it from past waves of globalisation? Several features do so. One, in particular, nevertheless remains poorly understood and has special importance for policy makers: the new, flexible, post–taylorist approaches to organising the production of goods and services, both within firms and in the way firms co–operate and compete with other firms. The paper returns to this phenomenon below, as the principal microeconomic force driving and shaping globalisation today. First, however, a few words on four other features of the current wave of globalisation which have been more widely discussed in the literature.

Deregulation

One feature embraces the movement to deregulate markets in OECD countries. Launched in the late 1970s by the Carter Administration as the principal US policy response to stagflation and stagnant productivity growth — combined with monetary "shock treatment" to cut inflation, which squeezed corporate profits and brought on the recession of the early 1980s (and was also the catalyst of the "Third World debt crisis" that erupted in 1982) — the US move to deregulate was quickly followed by Margaret Thatcher in the United Kingdom, and after 1980 in the United States by the Reagan Administration. Focusing mainly on services — financial markets, air and surface transportation, telecommunications (and energy in the United States) — Anglo–Saxon deregulation sought to improve the functioning of markets by stimulating competition. It put strong pressure on continental Europe to follow suit.

That pressure, and the combined effects of "Eurosclerosis" in the late 1970s (exacerbated by recession in the early 1980s) plus widespread perceptions in Europe that the centre of global economic gravity was shifting from the North Atlantic to the Pacific Basin, led the European Community in 1985 to launch the Single Market programme (complemented seven years later by the Maastricht Accords seeking to strengthen political unification and create a single European currency, which created the European Union). The EC's Single Market programme thus expressed continental Europe's deregulatory policy response to stagflation in Europe, Anglo–Saxon deregulation, and the perceived need to stimulate competition in Europe as the best means to strengthen European competitiveness in the global economy.

In response to the EC's announcement of the Single Market programme — and to its refusal, prior to that announcement, to support the US proposal to initiate a new round of multilateral trade negotiations — the United States also decided, for the first time, to pursue regional integration. It did so first with Canada (the 1988 Canada–US Free Trade Agreement), then with Mexico (which led to the signing of NAFTA in 1992) and has announced its intention to do so with all countries in the hemisphere (Bush's "Enterprise for the Americas" initiative and the Clinton Administration's proposed "Free Trade Agreement for the Americas"). The EC and especially the US regional initiatives acted in turn as an important stimulus to the South American Common Market agreement (Mercosur), the ASEAN Free Trade Agreement (AFTA), the APEC process, Malaysia's proposal to create an East Asian Economic Caucus and numerous smaller regional groupings among non–OECD countries. Many of these associations seek above all to attract foreign direct investment (FDI), if they are not openly a response to fears of diversion of investment and trade that could exclude them from the benefits of globalisation.

Deregulation in OECD countries has thus encouraged both the current wave of globalisation and the new wave of regional agreements. It has significantly increased competition and thereby helped to lower prices (thus user costs) and to improve product quality, especially in transportation, communications and financial services. Financial deregulation, in addition to facilitating the globalisation of financial markets (see

below), has also stimulated the development of new financial instruments crucial to financing the explosive growth of non–financial corporate mergers and acquisitions since the mid–1980s. These moves in turn have given a new impulse to regionalisation, whether as a vehicle for collective deregulation, as in Europe; as a means to lock in unilateral policy liberalisation, as in Mexico; or as a response to regionalisation elsewhere.

New Technologies

Commentary abounds on the radical impact, across sectors and countries, of the new microelectronics–based technologies. Suffice it here to warn against two sweeping — and largely mistaken — generalisations that have gained widespread currency. One says that thanks to the new technologies we have reached the age of truly global, "borderless" production; this statement, though valid for some firms in a few sectors, is mostly false, as noted earlier (Wells, 1992; Douglas and Wind, 1987). The other asserts that the new technologies have greatly increased productivity levels across manufacturing and service industries; but the truth lies more in a phenomenon of industrial organisation. Although the new technologies are indeed widely applied by manufacturing and service firms, the flexible, post–taylorist enterprises and networks, much more than taylorist firms, have reaped the productivity and competitive gains from the advent and rapid diffusion of the new technologies since the late 1970s.

Financial Globalisation

Only in the 1960s did international financial activity begin, slowly, to pick up again — after its disintegration during the inter–war period — with the creation of the Eurodollar and other unregulated "offshore" financial markets. It gained considerable momentum after the collapse of the Bretton Woods system of fixed but adjustable exchange rates in 1971–73 (speculative activity in the offshore markets was itself a major catalyst of that collapse) and with the recycling of petrodollars after 1973. It has grown most spectacularly since the late 1970s, under strong impetus from the deregulation of financial markets and the application of the new information and communications technologies. The value of cross–border assets held by banks more than tripled between 1983 and 1993, for example, and global foreign exchange transactions, which tripled between 1986 and 1992 alone, now amount on average to more than US$1 200 billion *per day* — over 100 times the value of total worldwide trade in manufactures and services combined — even after allowing for double counting due to local and cross–border inter–dealer transactions.

As one result, the size and volatility of exchange rate fluctuations among the major currencies have amplified; they became far greater in the 1980s and 1990s than anyone anticipated at the demise of the Bretton Woods system. Those fluctuations

have affected the physical location of production, as noted earlier, i.e. they furnish an important reason why globally competitive firms have increasingly sought to develop production capabilities *within* each of the major regions.

Financial deregulation and the globalisation of financial markets, much more than the globalisation of non–financial corporate activity, also have large responsibility for the widely perceived weakening of national economic policy sovereignty. It has become more difficult for central banks to control exchange rates, of course, but in policy terms that is the tip of the iceberg. As governments increasingly use interest rates to try to stabilise exchange rates — a stabilisation which becomes more important as economies become more open to trade and financial flows — interest rates become correspondingly less available as a tool to facilitate or stimulate growth (indeed, the effect is often the opposite, as all but the strongest open economies face pressure to raise or maintain high interest rates). It has also become much more difficult to tax capital, which tends to shift the fiscal burden more heavily onto the less mobile factor of production (labour), while governments' attempts to sustain their revenue bases by increasing consumption taxes have tended to have a regressive impact on income distribution as well.

Events in one country can also very quickly affect others, and big "mood swings" in global financial markets tend to affect all countries, whether or not they reflect underlying economic conditions in a particular one. Because highly mobile financial capital responds to regulatory differentials as well as interest rate differentials among countries, a tendency towards *competitive deregulation* has developed — some compare it to the competitive devaluations of the 1930s (Cerny, 1994) — which further weakens governments' economic policy sovereignty. While this weakening of national policy sovereignty arguably contributes, along with financial globalisation *per se*, to enhancing the efficiency of financial markets — and some also see it as a useful discipline on governments, as reducing politicians' and bureaucrats' ability to tax and spend, and to distort markets — it means that countries without efficient and profitable financial markets tend to suffer.

Opening of Non–OECD Countries

In little more than a decade most of the non–OECD world, comprising four–fifths of the world's population, has moved to privatise, liberalise, deregulate and compete actively on world markets. Most striking, until the 1980s only a handful of relatively small economies — the East Asian NIEs — successfully pursued strategies of export–oriented industrialisation, and even they were relatively protected and regulated (Hong Kong and to some extent Singapore were more the exceptions than the rule even among the NIEs). Today, even Korea and Chinese Taipei have moved to deregulate and liberalise their economies, while most non–OECD countries hope to emulate the manufacturing export success of the NIEs as they open up to global markets.

In many non–OECD countries democratisation or political liberalisation accompany the shift to greater reliance on and exposure to global markets. This means, in some cases, not only greater economic but also greater domestic political vulnerability to events in global markets. Widening domestic income disparities, which often accompany liberalisation, can exacerbate political vulnerability as well. The opening of non–OECD countries also increases their exposure to protectionist pressures in OECD countries — heightening concern about exclusion from the major *de jure* regional schemes — at a time when those pressures have risen. The process of deregulation and liberalisation can generate fierce resistance internally from powerful special–interest groups, to which governments may find it difficult to stand up. The combined result can be political instability that threatens not only democratisation where it is occurring, but economic reform itself.

From an OECD perspective, some see the massive opening of non–OECD countries as creating vast new areas for profitable investment and growth. Unfortunately, many others see it mainly as a threat, especially insofar as they believe — largely mistakenly — that trade with and investment in those countries costs jobs and undermines living standards (Lawrence, 1996).

Flexible Production and the Crisis of Taylorism

The preceding four features of globalisation — deregulation in OECD countries, new technologies, globalisation of financial markets, the opening of non–OECD countries — all facilitate and spur the process, and contribute to its specificity relative to earlier waves. Policy makers, however, must especially understand the *microeconomic* forces that drive the process, and how they differ from those that drove globalisation in the 1950s and 1960s. Put simply, the microeconomic foundation of globalisation in the 1950s and 1960s lay in the ongoing development and rapid international diffusion, at that time, of Taylorism — what Frederick Taylor himself liked to call "scientific management". Today Taylorism is in crisis. The development and international diffusion, despite resistance, of flexible, post–taylorist organisations now drives and shapes globalisation.

Taylorism first spread widely outside the United States during the 1950s and 1960s; "scientific management" took root and spread in Europe, extended to the so–called "modern" manufacturing sector in many developing countries, and found wide implementation in the centrally planned economies. As an approach to organising activity, it combined three main features (all nicely illustrated in Charlie Chaplin's movie *Modern Times*): *i)* a tendency to separate "thinking" and "doing", i.e. to separate the responsibilities of conception from those of execution throughout an organisation; *ii)* a tendency towards a very high degree of specialisation, which meant narrowly defined job responsibilities, at all levels of an organisation; and *iii)* belief in "one best way" of doing things (whence the term "scientific").

Taylorism served greatly to raise productivity levels worldwide, as well as to drive globalisation during the 1950s and 1960s. Over time, however, it built serious *rigidities* into the organisation of production (and the fabric of society), especially in the OECD countries where it was most developed and widespread. Those rigidities became a major cause of slowing productivity growth in the 1970s and of emergent stagflation in the latter half of that decade in the United States and Europe.

By the 1970s a growing number of European and Japanese firms had rapidly narrowed or closed the "technology gap" with their US counterparts and they began successfully to compete in the US market. More and more US firms, squeezed between slow productivity growth and growing competition at home, moved to relocate some of the more labour–intensive segments of their production, for their home market, to production sites in a few low–wage countries, mainly in Asia, Mexico and the Caribbean. Japanese firms' relocation of some of their more labour–intensive production to lower–wage countries in Asia also grew rapidly during this period, much of it for the US market and later also for Europe; this relocation occurred largely in response to rapid wage increases in Japan, revaluation of the yen, and growing US and European non–tariff barriers against Japanese exports (Kojima and Ozawa, 1984). To a lesser degree European firms, especially German firms, followed a pattern similar to US firms, with production going mainly to North Africa and the Mediterranean, Central and Eastern Europe (under communism) and Asia.

This relocation of production destined for OECD consumers, via FDI but also via sub–contracting and other "new" forms of investment[2], contributed substantially to the rapid growth during the 1970s of US and European imports of manufactures from a few lower–wage non–OECD countries, notably in Asia — countries which, as a result, gained the appellation "NICs" in 1979[3]. Those imports became a source of concern in the latter half of the 1970s, especially in the United States but also in Europe, because just as they reached a level that was no longer trivial (and US trade with the NICs turned to a deficit) stagflation and high unemployment hit both the US and European economies.

The accelerated relocation of production for OECD consumers to non–OECD countries carried into the 1980s, but with flagging momentum[4]. Contrary to popular perceptions in many OECD countries, in other words, and notwithstanding both a few well–publicised cases to the contrary — e.g. Swissair's relocation of backoffice operations to Bombay — and China's phenomenal surge of manufactured exports over the last decade, the relocation of production for OECD markets to low–wage production sites in other regions has not accelerated, overall, but has actually *decelerated* since the early to mid–1980s[5].

This deceleration has taken place for at least four reasons. First, the OECD countries' productivity growth in manufacturing has partially recovered (although it remains far below the levels attained in the 1950s and 1960s). Second, overall OECD corporate profits have rebounded strongly. Third, as already noted, the share of variable low–wage labour costs in OECD firms' total operating costs has trended downward.

Fourth and most important, the growth of flexible post–taylorist organisations, the increased importance of proximity between firms and both their customers and their suppliers — particularly in assembly–type production, which is most prone to relocation — and advances in automation technologies have given a new measure of *flexibility* to production in OECD countries (especially when they are used in flexible organisations).

The rigidities of Taylorism remain a problem in OECD countries, a major cause of the severe "structural" labour–market problems both in the United States (where they take the form of stagnant average wages, growing inequality and growing numbers of working poor) and in Europe (where they take the form of high long–term unemployment). Taylorist organisations still account for a large share of activity in OECD countries, and resistance to change in those organisations can be very strong[6].

That resistance and the very real effects of *domestic* labour–market problems, particularly when growth slows, feed protectionist pressures in the United States and Europe. Combined in some cases with perceptions of diminished national economic policy sovereignty, a further consequence has nourished mistaken perceptions that "globalisation" in general, and imports from low–wage non–OECD countries in particular, pose a major threat to US and European jobs and living standards. OECD policy makers, business leaders and (one would hope) economists have a responsibility to correct those mistaken perceptions and not simply ignore them.

It therefore has become crucial to distinguish between the crisis of Taylorism on the one hand and the microeconomic forces that are driving globalisation today on the other. Since the 1980s, a growing number of firms in OECD countries — across manufacturing and services — have moved to adopt flexible, post–taylorist forms of organisation. These organisations take many forms — ranging from industrial "clusters" that comprise large numbers of relatively small firms to large firms like Toyota, Motorola and Hewlett Packard — which often involve complex networking arrangements among firms that compete and co–operate simultaneously. These organisations nevertheless have a common denominator. They invert the logic of Taylorism: *i)* they tend to integrate thinking and doing in production; *ii)* they tend to define job responsibilities broadly and use much more teamwork; and *iii)* they emphasise continuous improvement and innovation in the way things are done as well as in what is produced. As learning organisations they exploit more successfully than taylorist groups the human intelligence, knowledge based on experience, creativity and flexibility of their workers. Successful flexible post–taylorist organisations can thus achieve productivity levels (of labour and capital) far superior to those attainable by taylorist firms. This competitive strength, at the microeconomic level, drives and shapes globalisation today. It, not exports from low–wage countries, is "changing the rules of the game" in global competition across manufacturing and modern services.

Regionalisation

Economists see globalisation — understood as the lowering of policy and technical barriers to international economic activity — as enhancing global welfare both by giving freer rein to the forces of competition worldwide and by increasing the possibilities for efficiency gains through greater international specialisation. They see *de jure* regionalisation, on the other hand, as capable of being either good or bad, with the outcome largely dependent on the action of policy makers. Perhaps for this reason, international policy debate over the last ten years has focused more on regionalisation than on globalisation *per se*.

Globally active multinational firms have tended in recent years [notably during the prolonged, difficult Uruguay Round negotiations (Wells, 1992)] to show markedly more interest in the reduction of policy barriers to *intra*–regional activity, than in the danger of increased *inter*–regional barriers to trade[7]. The apparent reason, in a nutshell, is that the stronger of them have moved to consolidate production capabilities *within* each of the major regions, as noted earlier. Weaker firms, on the other hand, are more likely to seek to block *de jure* regional integration, or to transform it into an instrument for regional protection (Stopford, 1992). This dichotomy illustrates both the potential strengths or advantages of *de jure* regionalisation as a policy tool and its potential risks or disadvantages.

Two of the strengths are that it increases the size of member countries' markets — which can also attract FDI to the region — and, because bargaining power in multilateral trade negotiations depends heavily on market size, it can increase members' collective bargaining power *vis–à–vis* non–members. It also can serve as an efficient vehicle for responding to the growing pressure engendered by globalisation for more international harmonisation or integration of traditionally "domestic" policies — on rules of competition, public procurement, protection of the environment, labour standards, product standards, etc. — in a way difficult or impossible to achieve among countries and peoples that do not share a strong sense of cultural or historical as well as geographic proximity. Indeed, the pressure for "deep" international policy integration or harmonisation engendered by globalisation, to which regional integration can be an important response, has also led in recent years to a blurring of the very distinction between domestic and international policy instruments.

With its strong focus on trade (including "border" and "non–border" measures, the potential for "trade creation" versus the risks of "trade diversion", etc.), the debate over regional integration agreements has nevertheless tended to overlook perhaps the single most important potential feature of those agreements as a policy tool — their potential to weaken, disrupt or dilute the often considerable growth–retarding and rigidifying powers of domestically entrenched special–interest groups, oligopolies and rent seekers, what Mancur Olson has called "distributional cartels", whose actions, both in the market and through politics, tend to dampen an economy's competitiveness at home and abroad (Olson, 1982). Whether or not diluting or disrupting the powers of such groups is a declared objective of regional agreements — often it is not — it

normally is necessary to stimulate the forces of domestic competition. *De jure* regional integration can thus become a key to strengthening domestic growth and competitiveness as well as the regional economy *vis–à–vis* the rest of the world.

The Relationship between Globalisation and Regionalisation

De jure regionalisation can thus respond to globalisation and, at the same time, help to strengthen the microeconomic forces that drive globalisation in the region by stimulating internal competition, as well as by significantly enlarging the domestic market. At the national level, *de jure* regionalisation can give impetus to much–needed reform legislation that otherwise might not overcome domestic opposition, and in doing so help open the economy to globalisation. It can enhance member states' policy stability and credibility, because it can lead to needed reform legislation and because international agreements are more difficult to change than domestic legislation, which can in turn be good for macroeconomic stability and attracting investment. Indeed, attracting FDI more than promoting trade *per se* has been the principal motivation behind many of the recent regional agreements, certainly in developing countries[8].

Policy makers must nevertheless recognise that the same special–interest groups most likely to oppose *de jure* regionalisation, if it threatens to undermine their domestic rent–seeking powers, are also among the political forces most likely to seek, if they are unable to block the process, to transform it into a tool for regional protection. The inter–war period provides a dramatic illustration of this possibility.

When *de jure* regionalisation becomes a tool for regional protection and loses its internal competition–enhancing effects — by failing adequately to disrupt or dilute the rent–seeking powers of domestic oligopolies and special–interest groups — it loses its value as a policy tool for strengthening regional growth and competitiveness in global markets. Indeed, whatever limited benefits it may still bring likely will not justify their cost to member states in terms of the reduced national policy autonomy that comes with increased *de jure* regional integration.

On the other hand, insofar as *de jure* regionalisation strengthens internal competition by enhancing "deep" policy integration among member governments and/or weakening the rigidifying powers and growth–retarding effects of entrenched distributional cartels, it can enhance member states' collective policy sovereignty *vis–à–vis* the market — hence the potential effectiveness of their policy measures — while strengthening the region's competitiveness *vis–à–vis* the rest of the world. In short, globalisation and regionalisation tend today to be mutually reinforcing, insofar — but only insofar — as policies to promote regionalisation seek above all to stimulate competition *within* the region, and to weaken, rather than protect, the rent–seeking powers of domestically entrenched oligopolies.

Regionalisation in Europe, the Americas and Asia

Concretely, regionalisation takes very different forms in each of the major regions, in each of the poles of the emerging tri–polar world economy. Europe has opted for "deep" policy integration among members of the European Union. The logic of the Single Market clearly does *not* involve protectionism, but promotes competition within the region to strengthen the competitiveness of European firms at home and abroad. The costs to some of adjusting to the Single Market, and perhaps even more so of preparing for the single currency, especially when growth is slow, nevertheless feed protectionist sentiments. For non–Europeans, the main challenge of European integration is to take advantage of whatever opportunities and stimulus to European growth the Single Market ultimately provides. For developing countries and NIEs, the main competitive test probably comes from the Central and Eastern European countries, which benefit from physical and cultural proximity to EU countries and some preferential access to EU markets, and likely will develop competitive strengths in manufactures that compete directly with those of developing and newly industrialising economies outside the region.

North America has followed a path of relatively shallow *de jure* integration under NAFTA, certainly from the US perspective, preceded by substantial *de facto* integration between the US and both the Canadian and Mexican economies. For Mexico a major motivation for NAFTA was to "lock in" the country's far–reaching unilateral policy reforms and to attract foreign investment. For countries outside the region, NAFTA's significance lies primarily in the risk of diminished US commitment to multilateral trade liberalisation and, for some countries, the agreement's potential to divert trade and investment to Mexico. It has also added to incentives for other developing countries to form sub–regional groupings among themselves, such as Mercosur in South America and AFTA in Southeast Asia.

In Pacific Asia, regionalisation takes basically a *de facto* form, driven by strong economic growth, particularly in the region's developing countries and NIEs. Countries and firms outside the region can share in the benefits of that growth, which looks likely to continue, by pursuing policies and strategies to develop their own competitive strengths in the region.

Implications for Developing Countries

The specific features of globalisation today, in particular the spread of flexible organisations and the crisis of Taylorism in the OECD countries, raise difficult questions about the long–term viability of growth strategies in developing countries based on an expansion of taylorist, low–skilled, low–wage labour–intensive production of exports for global markets — precisely at a time when many developing countries, as they

liberalise and open to global markets, hope successfully to pursue such strategies. Those strategies increasingly must recognise the importance for all firms, not just OECD–based firms, of proximity to their customers ("global localisation") and to their suppliers, reflecting the benefits of continuous information exchange as reinforced in flexible organisations. The declining share in OECD firms' total costs of variable low–skilled labour costs and the impact of flexible automation technologies on the competitiveness of production in OECD countries also weaken those strategies. Already, the importance of proximity, reinforced in some cases by protectionist pressures and/or *de jure* regionalisation in OECD countries, means that firms in NIEs and developing countries that want to compete in OECD markets increasingly find it necessary to invest directly for production in those markets.

Is it desirable or possible for developing countries to develop their own flexible, post–taylorist production capabilities? The answer on both counts is mixed. Compared to taylorist organisations, flexible organisations generally can produce efficiently a much wider range of products in a single plant, and their minimum–efficient scale of production of any given product is often significantly lower (Kaplinsky, 1993; Humphrey *et al.*, 1995). Smaller minimum–efficient output levels can in turn enhance the scope for healthy domestic price competition in smaller markets, thereby stimulating greater domestic productivity growth as well.

Flexible organisations also offer considerably greater possibilities than do taylorist firms to adapt product features, as well as output levels, to the demand requirements of specific groups — or small markets — without sacrificing quality or cost efficiency (as was so widely the case of taylorist firms producing in relatively small, but necessarily protected, developing country markets under import substitution). Moreover, because the key to achieving flexibility is organisational, not technological *per se*, the basic changes required in firms, and countries, that seek to develop flexible production capabilities, or to make the transition from taylorist to flexible production, are neither capital–intensive, nor therefore, for developing countries, foreign exchange–intensive. Indeed, flexible firms' much greater ability to produce in response to actual demand (because of their speed and adaptability), as opposed to taylorist firms' production to (unreliable) demand forecasts, combined with flexible producers' much smaller inventory requirements and their much smaller waste, offer important cost and foreign exchange–saving features that add to their potential competitive advantages for developing as well as for OECD countries. One should not underestimate the extent to which developing countries may benefit from greater flexibility than exists in most OECD countries, both in the economy and in prevailing attitudes, which could prove most valuable of all for the successful development of flexible, post–taylorist organisations in those countries.

Caveats and bad news exist too. First, even with minimum–efficient output levels significantly lower for flexible than for taylorist firms, for many products they still remain high relative to effective market size (purchasing power) in many small, low–income countries. Export–oriented strategies and access to OECD markets thus remain important for successful flexible producers in developing countries, although

the advantages to be gained from proximity also point to advantages for developing countries in pursuing greater integration among themselves as a complement to, or as a means to help strengthen, greater integration with OECD countries.

Second, lower minimum–efficient scales of production do not mean a reduction in the advantages to be derived from large firm size. The importance for flexible organisations of networks, which blur the boundaries and in important ways change the very nature of the firm, makes difficult the comparison of firm size between taylorist and flexible organisations (networks can be understood as an alternative to the dichotomy between markets and "hierarchies", i.e. an alternative to the ownership–based command structures of traditional firms). Yet the importance for flexible organisations of economies of *scope* — an importance often amplified by high fixed costs in R&D or in gaining access to technology, in marketing, in worker training, etc. — means that the advantages of large size accruing to networks can be significant. They point up significant advantages of large size for flexible organisations in developing as well as OECD countries, especially in the spheres of finance and marketing, while the essence of flexible organisations is to avoid the internal rigidities typical of taylorist organisations and large bureaucracies in general. While industrial "clusters" may provide a solution in some cases, for many firms in developing countries and NIEs that aspire to become, or remain, successful international competitors, the solution may lie in establishing tie–ups with or attracting investment by flexible organisations in OECD countries.

Third, and most serious, successful flexible production demands both well–functioning, modern transportation and communications infrastructure and human resources. The importance in flexible organisations of relatively firm–specific skills and more or less permanent on–the–job training means that the constraint on the development of flexible production capabilities will less likely come from a shortage of skilled labour in developing countries than from one of workers with strong literacy and numeracy skills ("trainability") — a problem not insurmountable for many countries over time[9]. The more binding constraint in many countries will likely concern the underdevelopment of infrastructure relative to the needs of flexible organisations.

Moreover, the greater robustness of taylorist organisations compared to flexible ones means that they may be better adapted, overall, to conditions in many developing countries — notwithstanding evidence of some successful flexible organisations in such countries as Zimbabwe, India and Indonesia (Kaplinsky, 1993; Humphrey *et al.*, 1995). Taylorist organisations tend to demand less infrastructure and human capital than flexible organisations and show less vulnerability to certain internal frictions. Both in their early years, in the United States, and more recently in many developing countries, taylorist organisations have proved remarkably effective in taking low–skilled, often illiterate people migrating out of peasant agriculture, or immigrating from overseas, who often speak different languages, and putting them to work so that, practically overnight, their productivity jumps several times over. For a country like China, say, Taylorism arguably still has much to offer.

Policy Implications

OECD Countries

For OECD countries, globalisation's main imperative demands increasing domestic flexibility in ways that strengthen rather than weaken social cohesion. Firms and managers face this task first and foremost, but governments face it as well — not least because they too are often organised along taylorist lines. All need to move beyond taylorist management and organisational precepts (and the dichotomy of markets and hierarchies) in order to embrace the transition to flexible, post–taylorist ways of thinking and organisation. Resistance to change, and blindness to the type of change required, slow the transition and make it more difficult; and the difficulties of transition prolong and exacerbate the severe structural labour–market problems that plague OECD countries. The regrettable but predictable tendency to look for scapegoats often leads people in those countries, mistakenly, to blame "globalisation" and imports from non–OECD countries.

The main policy imperative for OECD governments is therefore to facilitate and encourage the transition from taylorist to post–taylorist ways of thinking and organisation, to do so in ways that promote social cohesion, and, during the transition, to help voters better understand the nature of the problem. Policies should facilitate and promote microeconomic flexibility rather than succumb to pressures to resist change through protection or other measures to restrict competition. They should promote social cohesion, not only because the cost of rapid change without it can be high (demotivation, drugs, crime, instability), but because it fosters creativity and innovation, which facilitate change both in firms and in the fabric of society. Weak or declining social cohesion, in contrast, increases resistance to much–needed change, and prolongs and exacerbates the crisis of Taylorism.

Policies to facilitate and stimulate needed change at the microeconomic level start with macroeconomic policies that favour low interest rates and strong growth with low inflation. Such policies favour investment and new firm start–ups, hence flexibility as well as employment creation, and can create a virtuous circle because microeconomic flexibility also makes macroeconomic policies more effective. [Such policies may in turn call for throwing some "sand in the wheels" of international finance, if only to restore a modicum of autonomy to public monetary authorities (Eichengreen *et al.*, 1994)]. High interest rates and slow growth, in contrast, retard change and slow the development of flexible organisations while aggravating the already serious difficulties of taylorist firms.

"Structural" policies should focus on the development of human capital, on the creation and diffusion of both technological and organisational know–how, and on nurturing an entrepreneurial climate. Governments can, for example, facilitate firms' absorption of new technologies and nurture an entrepreneurial climate through measures

that promote investment in new information infrastructures (e.g. remove the regulatory barriers to market access and establish adequate standards to stimulate the creation of new and more effective services) and through measures that make better use of public procurement (e.g. encourage innovation through performance requirements, break up contract size, encourage supply consortia of small firms). Governments, especially local governments, often have a critical role to play in facilitating the development of industrial "clusters"; governments should also ensure that industrial assistance does not unduly favour large established firms at the expense of small new ones. Governments also can change financial accounting practices to allow skills to be treated as long–term assets, thereby improving incentives for firms and workers to investment in education and skill formation.

The important "public good" features of investment in education and human capital formation can, of course, justify direct government investment in public education, and the increasingly knowledge–intensive nature of competition today probably justifies increasing that investment. Just as globalisation blurs the boundary between manufacturing and services, between inter–firm competition and co–operation, and even the boundary of the firm itself, it and the spread of flexible organisations change both the frontier between public and private responsibilities in education, and the kinds of public training and education systems that are most needed. Since flexible organisations tend to require workers with *multiple* skills, many of those skills rather firm–specific, such organisations tend both to treat at least a core group of workers as long–term assets (rather than as variable costs) and to provide them with much more on–the–job training and continuous skill training than do taylorist organisations. What they most need from public education systems, therefore, is not so much investment in the formation of skilled but narrowly defined specialists, or a lot of investment in vocational training, but much more investment (and success) in the training of people with broad–based problem–solving skills, and the social and inter–personal communications skills required for teamwork, along with the "trainability" (preferably lifelong) required for flexibility.

OECD countries' "international" policies should have the same spirit of openness to change. Their trade policies should of course embrace trade with non–OECD countries, as well as among OECD countries, not only because it stimulates competition and growth at home and promotes global development — and because the contrary ultimately leads to sclerosis — but because non–OECD markets are fast–growing and will account for a large share of global demand growth. Even more important, globalisation today blurs the very distinction between "domestic" and "international" policies as it increases pressures on governments to engage in "deep" international policy integration. *De jure* regional integration can be a useful policy instrument in this regard, and a valuable means to enhance domestic competition, and hence efficiency and productivity growth, by weakening the rent–seeking powers of entrenched oligopolies and special–interest groups. It may not, however, shelter members from

the volatility of global financial markets, as the 1992–93 European monetary crisis illustrated. Most important, policy makers must ensure that regional schemes never become tools for regional protection.

Non–OECD Countries

Non–OECD countries face an even greater challenge in globalisation than do OECD countries, not least because it is a double challenge: first, to open to the global economy — a sea change for most — and second, to deal with the repercussions of globalisation and the crisis of Taylorism in the OECD countries. For most non–OECD countries, opening includes deep reductions in barriers to imports and capital flows along with far–reaching and often painful domestic reforms. It means significantly increased economic and political vulnerability to events in the global economy, including in global financial markets[10]. It raises delicate questions about the proper speed and sequencing of internal and external liberalisation and policy reform.

Dealing with the repercussions of both globalisation and the crisis of Taylorism in OECD countries means facing at least four additional challenges. First, it means dealing with the rise of protectionist pressures in OECD countries, including the limited but non–trivial risk that one or both of the major OECD regional groupings, in Europe and North America, may at some point become more protectionist. This risk also points up the growing dichotomy between the few non–OECD countries whose firms have the resources to invest in OECD regional markets as a means to compete in those markets, and the many non–OECD countries whose firms find it difficult to undertake such investment and — for this reason and others (e.g. the importance of proximity) — are increasingly threatened with exclusion from those markets, especially if they are not located in the same region.

Second, dealing with the repercussions of globalisation in the OECD countries means dealing with certain indirect effects of the globalisation of financial markets, such as volatile exchange rate fluctuations among the major currencies and pressure to engage in competitive deregulation. Third, it means dealing with the tendency of OECD countries to move towards "deeper" policy integration among themselves and either to exclude non–OECD countries from the process or, at best, to pressure them to follow suit or face marginalisation from the emerging "global" rules of the game and the risk of severely limiting both FDI inflows and access to OECD markets. Examples include pressures to recognise and better enforce intellectual property rights, to discuss WTO enforcement of "core" international labour standards, and eventually to join an OECD–negotiated Multilateral Agreement on Investment.

Above all, dealing with the repercussions of globalisation in the OECD countries means adapting to the spread of flexible production, including the impact of flexible automation technologies, the increased importance of proximity, the diminishing importance of low–skilled labour costs, the regionalisation of production, and the political fallout from the crisis of Taylorism in Europe and North America that includes

protectionist moves aimed specifically at imports from low–wage countries. Compared to such competitive assets as skills and trainability, flexibility, proximity, well–functioning modern infrastructure, political stability and sound macroeconomic policy, comparative advantage in low–skilled, labour–intensive products has diminishing value for developing countries as a source of strength for competing in global markets. Thus it is no small irony that just as most non–OECD countries — comprising four–fifths of humanity — finally turn outwards, with many seeking to become low–cost sites for production to serve global markets, a chorus of protectionist voices emerges in some OECD countries to blame unemployment and declining wages at home on a massive shift of production to low–wage countries that has not occurred and is unlikely to occur.

Non–OECD countries, like OECD countries, need domestic policies which allow and encourage their economies to benefit from the productivity–enhancing features and long–term growth dynamics of globalisation, and do so in ways that strengthen rather than weaken internal social cohesion. Many of the policy implications cited above for OECD countries apply broadly to non–OECD countries: pursue mutually reinforcing macroeconomic and structural policies; promote the development of human capital, and focus public investment in human resources on strengthening broad–based problem–solving skills (literacy and numeracy) along with inter–personal communications skills and "trainability" rather than narrowly specialised skills; facilitate the diffusion and absorption of technological and organisational know–how; promote investment in the development of modern infrastructure and the formation of industrial clusters; create an entrepreneurial climate — which in many non–OECD countries requires a lot of attention to creating and nurturing that all–important public good called the market (too often mistakenly assumed by economists, once government withdraws, to exist through immaculate conception!) — and to ensuring that markets are "contestable" (characterised by healthy inter–firm price competition), which may call for an explicit competition policy, and perhaps an independent and pro–active competition agency, as necessary complements to liberalisation, privatisation and deregulation. Governments should also ensure that participation in any *de jure* regional schemes serves to strengthen internal competition.

Last but not least come policies to facilitate access to technology, and to rapid technological change, which call, more than in the past, for a hospitable climate and policies to attract FDI — with all this entails in terms of political stability, sound macroeconomic policies and, for most non–OECD countries, policy transparency and credibility, convertible currencies, etc. It also points up the pressure globalisation today exerts on governments to compete to attract FDI. Such inter–governmental policy competition — within countries, at the sub–national level, as well as between countries — can conceivably induce socially beneficial government policies and action, such as increased public investment in human capital formation and in modern infrastructure. It can just as easily have the contrary effect, namely a costly and socially unwarranted escalation of subsidies and fiscal incentives to FDI — "bidding wars" — and/or a process of competitive deregulation that lowers standards of environmental

protection, for example, or exerts excessive downward pressure on labour standards. A further result can thus be to exacerbate fiscal deficits or otherwise divert resources from much–needed investment in, say, human resources and infrastructure — investment which can often actually do more in the long run to attract FDI as well as to raise economy–wide productivity levels. Similarly, excessive and therefore unsustainable incentives and/or policy competition can lead to policy instability — or perceptions of its likelihood — which increase uncertainty, weaken policy credibility, and can thus even have the perverse effect of reducing the inflow of the most sought–after kinds of FDI (in favour, perhaps, of short–term investments looking for a quick profit).

The risk of excessive policy competition to attract FDI, and the pressures of competitive deregulation, point to the growing need for non–OECD governments to enhance policy co–ordination and co–operation — at the sub–national as well as at the national levels — and to move beyond "shallow" policy integration to "deeper" international policy integration among themselves, as well as with OECD countries. *De jure* regional agreements can help here in some cases, as well as attract FDI — the latter because of the greater steadiness and credibility they can give to member governments' policies as well as the larger market they offer to investors.

Such agreements, however, must strengthen internal competition and thus stimulate domestic productivity growth. They can involve national governments (e.g. Mercosur, AFTA and the recently agreed ASEAN Investment Area) and they can involve sub–national governments (as in several of Asia's "growth triangles"). They can have particular value as vehicles for developing "deeper" *economic* integration, including the cross–border development of infrastructure, as well as for deeper policy integration where appropriate.

De jure regionalisation can in some cases also usefully strengthen relations between developing and developed countries, as in NAFTA. For these relations generally, however, a strong World Trade Organisation clearly has no substitute. Indeed, for many non–OECD countries, perhaps the single greatest threat of exclusion from globalisation stems, in policy terms, from the threat of exclusion from the process of "deep" policy integration among OECD countries. That process, driven by the microeconomic forces of globalisation, will continue.

The ultimate interest of OECD countries is to ensure that the process takes full account of conditions in non–OECD countries and integrates them in the global "rules of the game" in a way that promotes social cohesion within and between countries, along with efficiency and growth. The collapse of globalisation from 1914 to 1945, and all that accompanied that collapse, offers a stark reminder of what can happen when market forces lead to a breakdown in social cohesion and governments fail to respond adequately. Countries that try to close themselves off from globalisation, on the other hand, can expect to fare badly as well — as the legacy of Korea's Hermit Kingdom and that country's experience around the turn of the last century also remind us.

Notes

1. The three main reasons for this trend are *i)* the explosive growth of R&D expenditures, which are essentially fixed costs, *ii)* the phenomenal increase of investment in establishing global brand names, global marketing and distribution networks and global advertising, also essentially fixed costs, and *iii)* a growing tendency to treat a core group of qualified workers as long–term assets (mainly in post–taylorist firms), combined with automation and other labour–saving technological change (Oman, 1994).

2. FDI was the main vehicle in electronics and to a lesser degree in auto parts, whereas international sub–contracting with locally owned firms was the main vehicle especially in clothing, sporting goods and toys (Oman, 1984; Oman *et al.*, 1989).

3. The four Asian NICs' share of total OECD manufactured imports rose from 1.3 per cent in 1964 to 3.9 per cent in 1973, 5.4 per cent in 1980 and 8 per cent in 1985. In 1979, the OECD produced its first study of the impact on OECD countries of trade with the NICs (a term coined by that study). The trade of OECD countries as a group with the NICs, except for Japan, shifted from a surplus to a deficit in the early 1980s (US trade with the NICs had already shifted into deficit in the mid–1970s) (OECD, 1979; 1988).

4. That growth was given some new impulse by the recession of the early 1980s and especially by the high real interest rates that resulted from the monetary "shock treatment" of the late 1970s and early 1980s, which put a strong squeeze on corporate profits. In the late 1980s and early 1990s, high interest rates and stagnant growth also provided some new impetus in Europe, but mainly in France (whose firms had been slow to join the process before then). In Japan, *endaka* (a strong yen) both in the late 1980s and in the mid–1990s has induced new waves of relocation.

5. Average annual rates of growth of import penetration in OECD countries (the share of imports in domestic consumption) by manufactures from the Asian NIEs fell from the 1970s to the 1980s, according to OECD data, as follows (average annual percentage rates of growth):

	1970s	1980s		1970s	1980s
United States	14.5	10.7	United Kingdom	3.6	2.7
Germany	14.5	6.5	Netherlands	12.3	8.4
France	22.6	10.0	Japan	14.2	4.4

Import penetration by manufactures from other non–OECD countries decelerated even more markedly, and in some countries — Germany, the United Kingdom, the Netherlands, Japan — actually declined.

OECD data on manufactured imports from OECD and non–OECD countries in the latter half of the 1980s, as a share of domestic consumption in the OECD countries, show the following levels (percentages):

	Imports from OECD	Imports from non-OECD		Imports from OECD	Imports from non-OECD
United States	9	4.3	United Kingdom	20	3
Germany	22	3	Netherlands	58	7
France	25	3	Japan	2.9	2.6

6. The resistance often starts with top managers who built highly successful careers applying the principles of Taylorism and who find it difficult to perceive problems, much less solve them, other than through taylorist lenses. Resistance by middle managers tends to be very strong, perhaps more understandably, because their jobs are likely to disappear or at least change beyond recognition in any transition from taylorist to flexible organisation. Skilled workers often see a threat because their specific skills, perhaps built up over a lifetime of experience, may be too narrowly specialised for the needs of a flexible organisation. Unskilled workers are threatened because flexible organisations have little use for workers who lack "trainability" and the basic literacy, numeracy, social and interpersonal communications skills required for teamwork and problem–solving.

7. Low *investment* barriers between, as well as within, regions are important for those firms, of course, but even worst–case scenarios, in terms of the collapse of the multilateral trading system and the formation of relatively closed regional blocs, foresee little danger of increased barriers to inter–regional investment.

8. Free flows of FDI between regions should in turn offset whatever small trade–diversion effects the regional agreements may have.

9. Flexible organisations' more "consensual" approach to work organisation and their consequent vulnerability to any significant breakdown in teamwork, consensus and internal communications also raise difficult–to–answer questions about the viability of flexible production in countries where extreme social inequality, political instability and/or undemocratic political institutions prevail.

10. Developing countries that open their financial markets can benefit from capital inflows — although financial inflows do not necessarily lead to productive investment — but they must also deal with the risks of strong *surges* in such flows: a strong *inward* surge can drive up the exchange rate and undermine export competitiveness; a strong *outward* surge, as in the Mexican peso crisis, can also have devastating effects.

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Financing Economic Reform: Mobilising Domestic Resources and Attracting the Right Kind of External Resources

Maxwell J. Fry[1]

Summary

Most newly emerging market economies need to increase resources available for investment. One of the few effective ways of doing this is to reduce the government's deficit. The first section of this paper provides econometric evidence from a sample of 111 countries showing that government deficits reduce national saving and economic growth, and that growth is a major determinant of saving ratios. The paper then investigates the four major ways that governments can finance their deficits: *i)* monetising the deficit by borrowing from the central bank; *ii)* reducing the interest cost of borrowing by thrusting debt down the throats of captive buyers, primarily commercial banks; *iii)* borrowing abroad in foreign currency; and *iv)* borrowing from voluntary domestic private sector lenders. The typical OECD country finances half of its deficit from voluntary domestic sources, while the typical developing country finances only about 8 per cent of its deficit from this source.

This matters because, for any given government deficit, greater use of the first three sources is associated with lower saving ratios and lower rates of economic growth. Although government deficits generally do not help economic growth, financing them by borrowing from voluntary private sector lenders appears to minimise the damaging effects of any given deficit. Economic efficiencies improve not only through the use of the market–pricing mechanism but also through the transparent presentation of the costs of government expenditures. When the costs of borrowing are borne openly by the public and not hidden through the use of captive buyers, the true resource costs of government spending can be properly incorporated into economic choices.

Estimates of a simultaneous–equation model — in which the real deposit rate of interest and the black market exchange rate premium affect saving, investment, export growth and output growth — corroborate earlier findings that financial distortions have a minuscule *direct* effect on saving. They do indicate, however, that financial distortions reduce investment and export growth. In turn, lower investment and export growth reduce output growth rates. Financial distortions also reduce output growth directly, possibly through an impact on investment efficiency. Because a major determinant of saving is the output growth rate, saving is influenced substantially, albeit *indirectly*, by financial distortions through their effects on investment, export growth, and output growth.

The policy conclusions for newly emerging market economies are: *i)* reduce the government deficit; *ii)* if deficit reduction is infeasible, finance the deficit by selling government debt in voluntary domestic markets; *iii)* remove financial distortions; and *iv)* improve the investment climate and facilitate foreign direct investment that then participates in the economy's growth.

Introduction

Over the past two decades, world saving as a proportion of world income has fallen. As world saving has shrunk, so the world real interest rate rose from 0.8 per cent in 1971–78 to 5.3 per cent in 1978–85 before declining to an estimated 3.2 per cent in 1986–97 (IMF, 1996*a*, p. 187)[2]. Against this background, concern over domestic resource mobilisation has increased and foreign direct investment (FDI) has appeared increasingly attractive to developing countries facing declining domestic investment and higher costs of foreign borrowing.

The rise in government deficits provides the primary reason for the decline in world saving. While government deficits have various negative effects on an economy, the second section of this paper is concerned with the *differential* impacts of financing a given deficit in alternative ways. A key question asks, "What effects on saving and growth arise from financing a deficit through central bank credit, reserve and liquid asset ratio requirements imposed on commercial banks, loans from abroad and voluntary lending by the private sector?" One point to stress at the outset is that the impact of borrowing from abroad or from voluntary domestic lenders will depend on the amount previously borrowed — the level of debt accumulated from past borrowing affects the impact of additional borrowing.

Faster growth reduces deficits and increases national saving. Some government policies retard growth. Hence, the third section presents estimates of a simultaneous–equation model in which financial conditions fostered by government affect saving, investment, export growth, and output growth. This section concludes that financial distortions imposed by government policies influence saving substantially, albeit *indirectly*, through their effects on investment, export growth, and output growth.

While foreign debt accumulation leads to capital flight and reduces resources available for investment after a certain point, FDI appears to avoid the negative effects of debt accumulation as a source of foreign saving. It seems an attractive form of capital inflow because it involves a risk–sharing relationship with the suppliers of this type of foreign capital. This kind of risk sharing does not exist in the formal contractual arrangements for foreign loans. Furthermore, as the World Bank (1993, p. 3) claims, there may be dynamic benefits: "Foreign direct investment is a large and growing source of finance that may help developing countries close the technology gap with high–income countries, upgrade managerial skills, and develop their export markets".

Globally, FDI has increased dramatically over the past decade, but most of this increase has occurred in the industrial countries. In the developing countries, FDI has concentrated heavily among a small number of countries; only 18 countries received over 90 per cent of FDI inflows to developing countries in 1990. Half of this total flowed to eight Pacific Basin developing market economies — Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Chinese Taipei and Thailand. Given that neither Korea nor Chinese Taipei has shown strong interest in attracting FDI, it may seem surprising that these economies feature in this group of developing countries, but it may also support the view that explicit incentive packages are not the key determinants of FDI flows. Without doubt, a much more important determinant in these countries has been their superlative investment climates (Fry, 1991, 1993).

Effects of Alternative Ways of Financing Government Deficits on National Saving

The Fiscal Approach to Inflation and Financial Repression

In practice, many governments find it virtually impossible to satisfy their intertemporal budget constraint with conventional tax revenue, which may indeed be possible only by relying on revenue from the inflation tax or reducing interest costs through financial repression. The past 25 years have seen increasing recognition of the costs associated with both. As a result, many governments have attempted to move away from these two methods of satisfying their intertemporal budget constraints. *Ceteris paribus*, this involves increasing conventional tax revenues or reducing expenditures on goods and services as a proportion of GDP. The higher the growth rate, the easier it is to implement either or both of these alternatives. Furthermore, a higher growth rate eases the budget constraint itself. Conceivably, policies of price stability and financial liberalisation could pay for themselves if they raised the growth rate sufficiently.

Such an outcome is undoubtedly wildly optimistic in almost all cases. While inflation and financial repression certainly damage growth, only countries experiencing extraordinarily high and volatile inflation or seriously negative real interest rates could hope that price stability and financial liberalisation would increase economic

growth sufficiently to reduce the deficit. Yet in such countries, government deficits typically reach double–digit proportions of GDP. Unless concomitant additional measures reduce the primary deficits in these countries, abandoning these two distortionary, tax–like revenue sources may well lead to worse instability involving excessively *high* real interest rates. Real interest rates may soar to stratospheric levels, as they have in a number of developing countries over the past two decades. Such pathologically high rates damage economic growth just as much as strongly negative real rates.

Deficits, Saving and Growth

Figure 1 presents the period–average relationship between national saving ratios and government deficits for 111 sample countries (21 richer OECD countries and 90 developing countries) for which government deficit and the relevant national income data exist[3]. With all available annual observations for the period 1970–95 pooled in a fixed–effect model, the relationship between the ratio of national saving to GNP *SNY* and the government deficit as a ratio of GDP *GDY* is highly significant (2 166 observations, *t* statistics in parentheses):

$$\begin{gathered} SNY = -0.291(GDY) \\ (-10.033) \\ \overline{R}^2 = 0.718 \end{gathered} \tag{1}$$

No intercept is reported because the fixed–effect model estimates separate constants for each country. There are therefore 111 intercepts estimated in this equation. The period–average data for the 111 countries also indicate a significantly positive relationship between saving *SNY* and growth *YG*, as shown in Figure 2. The pooled fixed–effect estimate is (2 242 observations):

$$\begin{gathered} SNY = 0.230(YG) + 0.697(SNY_{t-1}) \\ (11.278) \qquad (46.532) \\ \overline{R}^2 = 0.863 \end{gathered} \tag{2}$$

Figure 1. **National Savings Ratios and Government Deficits in 111 Countries, 1979-93**

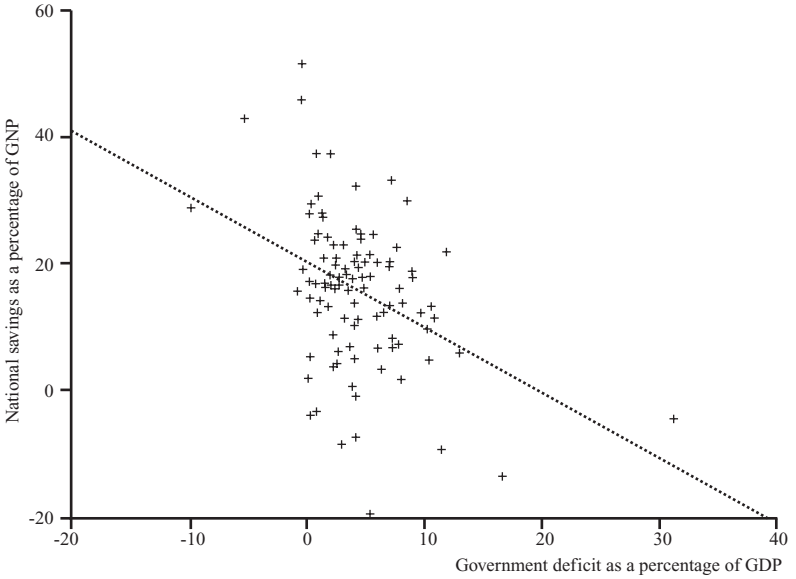
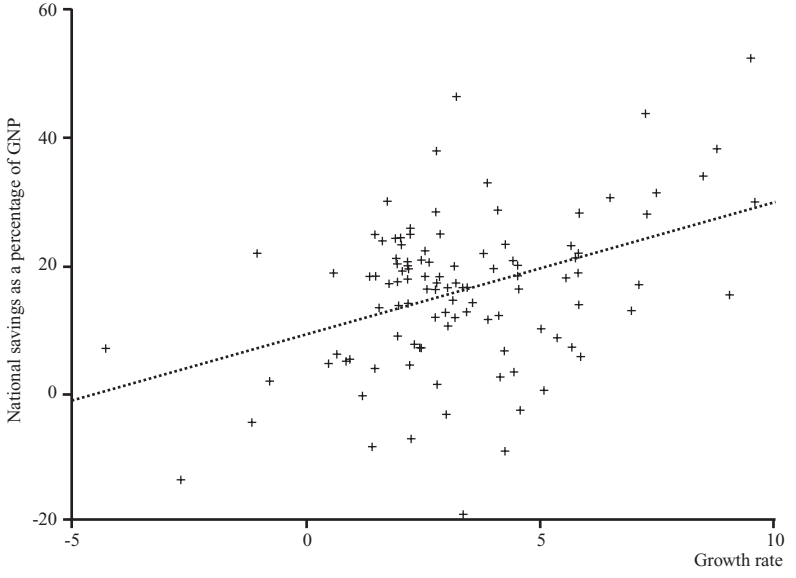


Figure 2. **National Saving and Growth Rates in 111 Countries, 1979-93**



The Central Bank and Inflationary Finance

While a larger government deficit is associated with lower saving and lower growth, the actual magnitudes of the effects of deficits on growth likely depend on how deficits are financed. To the extent that this occurs through the inflation tax or financial repression, deficits reduce saving and growth by considerably more than they do when financed by voluntary domestic purchases of government debt. The typical developing country financed about 30 per cent of its deficit from its central bank over the past 15 years. One way of examining the effect of the government's source of borrowing on saving and growth specifies a functional form in which the effect of the deficit depends on the way it is financed. One might specify an equation of the form

$$SNY = b_0 + (b_1 + b_2 CBD) \cdot GDY \tag{3}$$

which can be simplified to

$$SNY = b_0 + b_1 GDY + b_2 (CBD \cdot GDY) \tag{4}$$

In other words, the coefficient of *GDY* is variable and depends on the proportion of the deficit that is financed by the central bank *CBD*.

The estimate of equation 4 using all available annual observations for the period 1970–95 in a fixed–effect model gives (2 039 observations):

$$\begin{gathered} SNY = -0.180(GDY) - 0.232(GDY \cdot CBD) \\ (-5.777) \qquad (-11.569) \\ \overline{R}^2 = 0.723 \end{gathered} \tag{5}$$

Evidently, the greater the proportion of a given deficit financed by the central bank, the lower the saving ratio. A government deficit equal to 10 per cent of GDP reduces the saving ratio by 1.8 percentage points but, if it is financed entirely from the central bank, the saving ratio is reduced by a further 2.3 percentage points, and the overall reduction in saving is 4.1 percentage points.

A corresponding estimate of the growth rate is (2 030 observations):

$$\begin{gathered} YG = -0.093(GDY) - 0.041(GDY \cdot CBD) \\ (-4.000) \qquad (-2.752) \\ \overline{R}^2 = 0.147 \end{gathered} \tag{6}$$

Again, the greater the proportion of a given deficit financed by the central bank, the lower the rate of economic growth. When the government's deficit reaches 25 per cent of GDP, financing it entirely from the central bank reduces growth by about one percentage point more than it is reduced when there is no borrowing from the central bank.

Tax theory suggests that the optimal tax structure should equalise distortions at the margin from alternative tax sources. To the extent that in practice all tax sources produce some distortion, then it follows that the inflation tax should be used up to the point where its distortionary costs equal the distortionary costs of other tax revenues. The practical problem is that setting fixed tax rates on petrol or cigarettes is relatively easy, while setting a fixed tax rate on money through inflation is not. In practice, therefore, the choice may be between low and stable inflation on the one hand or higher and more variable inflation on the other. If so, a fiscal policy that does not rely on inflation as a source of government revenue is surely preferable to one that does.

Financial Repression

One way governments finance expenditures in excess of tax revenue is to force private sector agents to buy government securities at below–market yields. They can require contractors to hold government bonds as security when bidding for government contracts. They often oblige insurance companies and pension funds to hold larger proportions of assets in government securities than they would choose voluntarily. Commercial banks, however, make up the largest captive market for government securities. By setting high liquid asset ratios and making government securities the only assets eligible to satisfy this requirement, governments can borrow substantial amounts at below–market rates of interest. Indirectly, banks lend at zero interest to governments through the reserve requirement.

How much does this financial repression damage economic growth? One can estimate the effects of high reserve requirements, high proportions of domestic credit expropriated by government and distorted real interest rates on saving and growth. Denoting the ratio of domestic credit to government as a percentage of total domestic credit *DCGR*, the relationship between *DCGR* and *GDY*, the government deficit as a proportion of GDP, using annual data in a fixed–effect model is (1 875 observations):

$$\begin{aligned} DCGR &= 0.684(GDY) \\ &\quad (6.537) \\ \overline{R}^2 &= 0.595 \end{aligned} \tag{7}$$

Evidently, a higher government deficit is associated with a higher proportion of domestic credit expropriated by government.

The more the government expropriates from the banking system, the lower is the saving ratio for any given deficit (1 785 observations):

$$SNY = -0.086(GDY) - 0.183(GDY \cdot DCGR) - 0.038(DCGR) \quad (8)$$
$$(-2.048) \qquad (-2.474) \qquad (-5.046)$$
$$\overline{R}^2 = 0.674$$

In this equation, both deficits and credit expropriation by the government reduce saving independently. They also exert a negative, interactive effect similar to that produced in the case of central bank financing of the deficit.

Higher *DCGR* ratios are also associated with lower growth rates, even after controlling for the deficit (1 826 observations):

$$YG = -0.133(GDY) - 0.022(DCGR) \quad (9)$$
$$(-4.508) \qquad (-2.908)$$
$$\overline{R}^2 = 0.132$$

The ratio of the commercial banks' reserves to deposits provides an alternative indicator of captive–buyer government finance. First, higher deficits *GDY* are associated with significantly higher reserve/deposit ratios *RD* (2 041 observations):

$$RD = 0.364(GDY) \quad (10)$$
$$(6.431)$$
$$\overline{R}^2 = 0.593$$

Second, period–average (1979–93) national saving ratios *SNY* and reserve/deposit ratios *RD* are negatively associated (103 observations):

$$SNY = 0.222 - 0.327(RD) \quad (11)$$
$$(12.594) \quad (-4.524)$$
$$\overline{R}^2 = 0.160$$

Finally, higher period–average (1984–88) reserve/deposit ratios *RD* are associated with lower growth rates *YG* (96 observations):

$$YG = 0.044 - 0.046(RD) \quad (12)$$
$$(10.581) \quad (-2.719)$$
$$\overline{R}^2 = 0.063$$

The negative relationships between growth, on the one hand, and both the proportion of domestic credit expropriated by government and the reserve/deposit ratio on the other, suggest that the more the government takes from the financial system at below–market rates, the lower the return to depositors and so the less willing the public becomes to hold deposits. This produces a doubly destructive effect on the ability of the banking system to lend for productive investment, both reducing its deposit base and arrogating to government a larger share of the smaller pie.

In fact, financial repression usually does even more damage. Captive buyers receive below–market returns on their forced holdings of government debt — a method of government deficit financing typically accompanied by a range of financially repressive measures that include interest rate ceilings on bank deposits, loans and various other financial claims. With fixed interest rates under conditions of high inflation, the concomitant negative real interest rates produce growth–inhibiting effects (Fry, 1995).

Table 1 indicates that the dispersion in real interest rates increased considerably over 1979–93. Nevertheless, the standard deviation actually fell in the OECD country group, with Iceland's double–digit negative real rate in 1979–83 rising to zero in 1989–93. In the developing country group, however, the standard deviation of real interest rates rose from 9.5 in 1979–83 to 39.8 in 1989–93. Not only did some countries post larger negative rates in the last five–year period, but the incidence of pathologically high positive real interest rates also increased.

Table 1. **Real Interest Rates, 1979-93**
(Percentages)

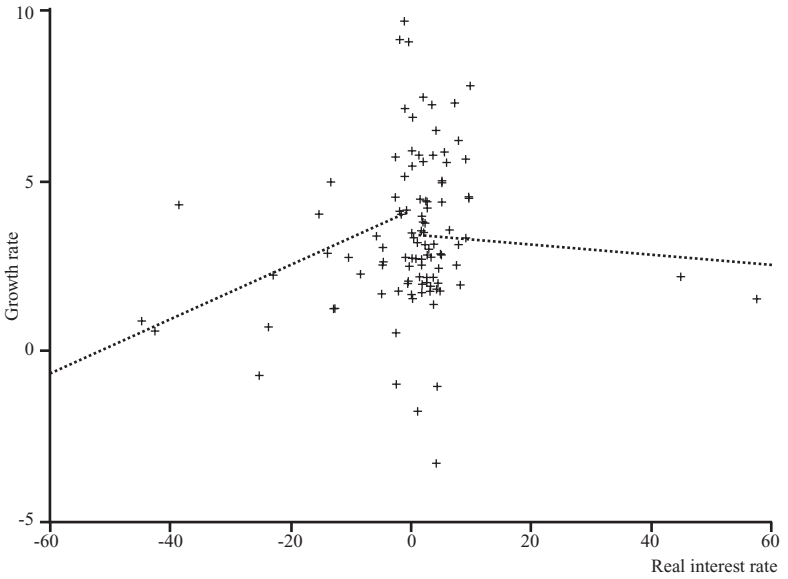
	All Countries			
Statistic	1979-93	1979-83	1984-88	1989-93
Mean	-2.6	-2.3	0.6	-0.5
Median	1.8	-0.8	3.2	2.8
Maximum	57.8	15.8	240.8	144.4
Minimum	-152.9	-38.5	-116.9	-224.8
S.D.	23.0	8.5	30.6	35.3
	OECD Countries			
Statistic	1979-93	1979-83	1984-88	1989-93
Mean	2.9	0.4	3.9	4.4
Median	3.3	1.0	4.4	4.0
Maximum	5.1	4.1	6.7	9.0
Minimum	-5.0	-11.8	-3.1	-0.1
S.D.	2.1	3.4	2.0	2.2
	Developing Countries			
Statistic	1979-93	1979-83	1984-88	1989-93
Mean	-4.0	-3.2	-0.3	-1.8
Median	0.4	-1.6	1.8	2.1
Maximum	57.8	15.8	240.8	144.4
Minimum	-152.9	-38.5	-116.9	-224.8
S.D.	25.5	9.5	34.6	39.8

Source: IMF, *International Financial Statistics*, CD-ROM, March 1996.

In the developing country group, real interest rates ranged from –38.5 per cent to +15.8 per cent in 1979–83 compared with –224.8 per cent to +144.4 per cent in 1989–93. The proportion of real interest rates above 10 per cent in developing countries doubled from 5.2 per cent in 1979–83 to 10.9 per cent in 1989–93, but the proportion of real interest rates below –5 per cent in developing countries fell from 30.1 per cent in 1979–83 to 13.6 per cent in 1989–93. Note that the violent fluctuations in countries of the former Soviet Union did not influence this increasing dispersion. Among all economies in transition only China, Hungary, Poland and Romania are included in the sample.

Using average rates over 1979–93, Figure 3 shows a positive relationship between growth *YG* and negative real interest rates *RR* and a negative relationship between growth and positive real interest rates.

Figure 3. **Average Real Interest Rates and Growth Rates in 111 Countries, 1979-93**



According to economists of almost all persuasions, financial conditions may affect the rate of economic growth in both the short and medium runs. James Tobin's (1965) monetary growth model predicts a negative impact of a higher real return on money holdings in the medium run but has nothing to say about the short run. The McKinnon–Shaw school (McKinnon, 1973; Shaw, 1973) expects financial liberalisation (institutional interest rates rising towards their competitive free–market equilibrium levels) to exert a positive effect on the rate of economic growth in both the short and medium runs. The neostructuralists predict a stagflationary outcome

(accelerating inflation and lower growth) from financial liberalisation in the short run, but in the medium term the saving ratio may increase enough to outweigh the negative influence of portfolio adjustments. In practice, neostructuralists, with the possible exception of Edward Buffie (1984), view a dominant saving effect as unlikely.

A simple way of discriminating between the McKinnon–Shaw school and others would examine episodes of financial liberalisation and see whether these were accompanied by higher or lower rates of economic growth. In practice, however, other economic reforms (such as fiscal, international trade and foreign exchange reforms) accompany most clear–cut cases of financial liberalisation, making it virtually impossible to isolate the effects of financial components of the reform package. This is unfortunate, because causality can be inferred when financial conditions have been deliberately and substantially changed, as in the case of a discrete financial liberalisation. Examining the association between financial conditions and economic growth over time provides in itself no evidence of causality. This caveat applies to the examination below of the empirical evidence on the association between financial conditions and rates of economic growth.

Referring to work by Guillermo Calvo and Fabrizio Coricelli (1992), José De Gregorio and Pablo Guidotti (1993, p. 11) claim that real interest rates are not a good indicator of financial repression. They suggest that the relationship between real interest rates and output growth might resemble an inverted *U* curve:

> "Very low (and negative) real interest rates tend to cause financial disintermediation and hence tend to reduce growth, as implied by the McKinnon–Shaw hypothesis ... On the other hand, very high real interest rates that do not reflect improved efficiency of investment, but rather a lack of credibility of economic policy or various forms of country risk, are likely to result in a lower level of investment as well as a concentration in excessively risky projects."

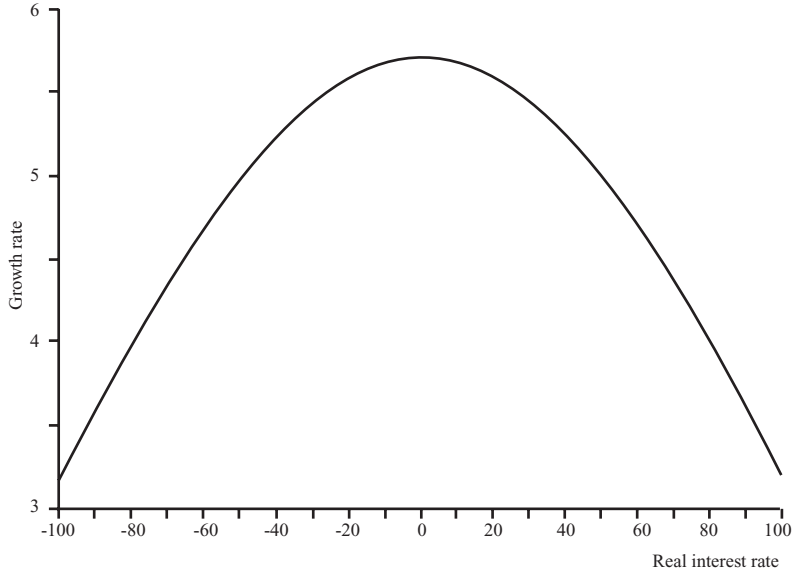
In other words, large negative and large positive real interest rates may well exert the same deleterious effect. Hence, De Gregorio and Guidotti abandon real interest rates in favour of domestic credit to the private sector divided by GNP as a measure of financial development.

The point made by De Gregorio and Guidotti (1993) holds up well with the data set prepared for this study, as shown in Figure 3. Using annual real interest data for 1970–95 for 85 developing countries, an equation of the form $YG = ß_0+ß_1(RR+ß_2)\cdot(RR+ß_2)$ captures the relationship between the annual rate of economic growth *YG* and the real rate of interest *RR*. Since the parameter $ß_3$ was not significantly different from zero, although its negative value implies that growth is maximised at some positive real interest rate, it is dropped from the estimate. A pooled fixed–effect estimate including both the squared real interest rate and the absolute value of the cubed real interest rate gives the following result (1 296 observations):

$$YG = -0.033(RR^2) + 0.008(|RR|^3)$$
$$(-3.949) \qquad (3.598) \tag{13}$$
$$\bar{R}^2 = 0.163$$

Using equation 9, the effect of a rising real interest rate on growth is illustrated in Figure 4. Evidently, growth is maximised when the real interest rate lies within the normal range not substantially different from zero. The range –5 per cent to +10 per cent provides a rule of thumb for the normal or tolerable range, with lower or higher rates viewed as pathological.

Figure 4. **Non-linear Effect of Real Interest Rates on Growth Rates, 1970-95**



As a technique for reducing government borrowing costs, financial repression has adverse effects on economic growth, but abandoning financial repression as a cost–reducing device for the government deficit may result in extraordinarily high real interest rates that can be just as damaging. Experience indicates that to be successful, financial liberalisation must be accompanied by fiscal reform aimed at ensuring that government debt will not explode in its aftermath.

In practice, financial repression appears to have yielded government revenue of the order of 2 per cent of GDP on average in samples of developing countries (Fry, Goodhart and Almeida, 1996, p. 36; Giovannini and de Melo, 1993). If this revenue from financial repression produces stable government finances, its loss requires higher revenue from alternative sources or concomitant expenditure cuts. Unless the government commits to fiscal reform in conjunction with financial liberalisation, financial repression may offer the lesser of two evils. "Good–bye financial repression, hello financial crash" is the verdict of Carlos Diaz–Alejandro (1985) on the Latin American experiments with financial liberalisation since the mid–1970s. If government expenditure cannot be reduced or traditional tax revenue increased, abandoning financial repression may lead to an explosion in government debt, economic instability and lower economic growth.

Foreign Debt Accumulation

As an alternative to inflationary finance or financial repression, government borrowing from abroad might seem benign, at least in the initial stages. Inevitably, however, the government faces the same intertemporal budget constraint whether it borrows at home or abroad. The only difference lies in the possible solutions to debt build–up. Over the past two decades, a number of developing countries have faced serious difficulties in servicing their foreign debts. Slower or even negative economic growth and accelerating inflation have accompanied typical foreign debt crises.

Table 2 provides some statistics on the behaviour of government and government–guaranteed foreign debt in 79 developing countries for which at least some debt and deficit data are available over 1979–93. While foreign debt as a percentage of GDP increased, so too did its standard deviation. The maximum debt ratio rose from 117 per cent in 1979–83 to 346 per cent in 1989–93. Rising foreign debt ratios give cause for concern; earlier work on the effects of foreign debt accumulation suggests that when debt exceeds about 50 per cent of GDP instability occurs unless decisive measures stabilise or reduce the debt/GDP ratio (Fry, 1989).

Table 2. **Government and Government-guaranteed Foreign Debt as a Percentage of GDP in 79 Developing Countries, 1979-93**

Statistic	1979-93	1979-83	1984-88	1989-93
Mean	43.9	25.9	46.1	56.1
Median	32.9	20.7	39.7	37.9
Maximum	212.8	117.0	185.6	364.4
Minimum	1.3	0.6	1.1	0.5
S.D.	37.6	19.4	34.5	59.0

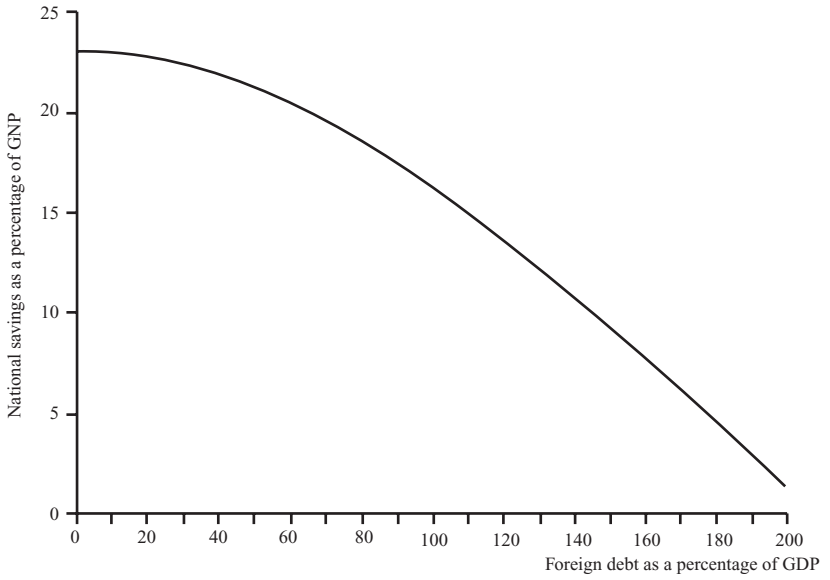
Source: World Bank, *World Data 1995*, CD-ROM, September 1996.

Using annual data for 69 developing countries with a minimum set of ten observations, the most satisfactory functional form among non–linear, fixed–effect models to estimate the relationship between national saving ratios and foreign debt ratios gives the following result (1 473 observations):

$$SNY = -0.082(DTGY^2) + 0.014(DTGY^3)$$
$$(-11.469) \qquad (8.258) \qquad (14)$$
$$\overline{R}^2 = 0.677$$

Figure 5 shows the effect of a rising foreign debt ratio on the national saving ratio. Consistent with the results reported earlier, the negative impact of foreign debt accumulation, not pronounced at low levels, increases as the debt ratio rises.

Figure 5. **National Saving and Foreign Debt Ratios, 1970-95**

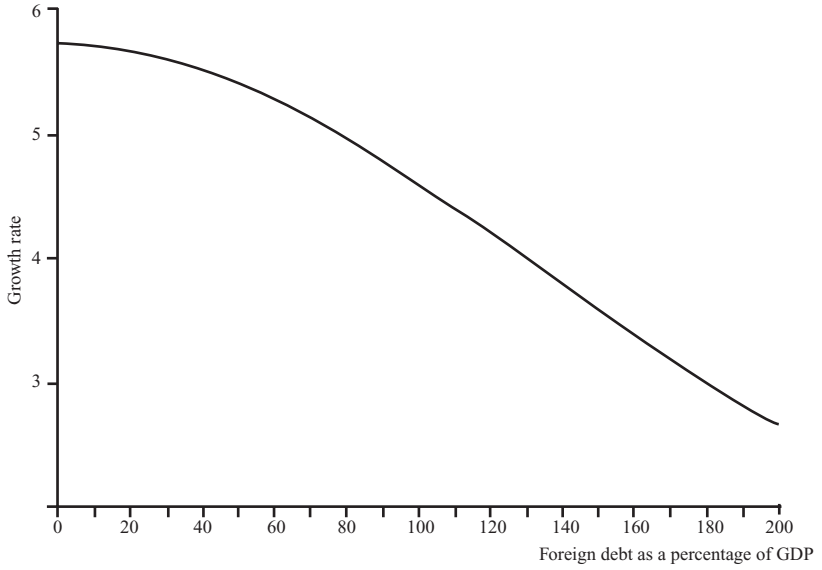


Again using annual data, the best non–linear estimate of the growth rate is (1 495 observations):

$$YG = -0.015(DTGY^2) + 0.004(DTGY^3)$$
$$(-2.587) \qquad (2.753) \qquad (15)$$
$$\overline{R}^2 = 0.113$$

Figure 6 shows the effect of a rising foreign debt ratio on growth. As with the effect on saving, debt accumulation has no pronounced effect on growth until the debt ratio exceeds about 50 per cent of GDP.

Figure 6. **Growth Rates and Foreign Debt Ratios, 1970-95**



Macroeconomic policies designed to stimulate saving (or to depress investment) can counter the tendency to overborrow. Higher saving (or reduced investment) depreciates the real exchange rate, which in turn increases exports and reduces imports. Foreign lenders might force a cold–turkey cure on a heavily indebted developing country by cutting off further net capital flows. The developing country could retaliate by repudiating its foreign debt. Alternatively, the necessary adjustments to saving (or investment) can be voluntary and possibly more gradual. In either case, the five–equation model reported in Fry (1989) indicates that growth should accelerate as the debt burden recedes.

That some developing countries have overborrowed (and some lenders have overlent) is certainly not a new finding. Among others, Michael Bruno (1985), Richard Cooper and Jeffrey Sachs (1985), Diaz–Alejandro (1985), Arnold Harberger (1986) and Ronald McKinnon (1991) provide explanations for why private sectors will borrow more abroad than is socially optimal unless restrained from doing so.

Voluntary Domestic Markets

So far, this section has drawn the negative conclusion that excessive use of inflationary finance, financial repression and excessive borrowing from abroad to finance government deficits reduce economic growth. Over 1979–93, however, the median OECD country financed over 50 per cent of its government deficit from voluntary lending by the domestic private non–bank sector *NBD*, while the representative developing country financed only 8 per cent of its government deficit in this way.

The method developed above serves to examine the effect of the government's source of borrowing on saving and growth. The functional form makes the effect of the deficit depend on the way it is financed. In this case, therefore, an equation of the form

$$SNY = b_0 + (b_1 + b_2 NBD) \cdot GDY \tag{16}$$

can again be simplified to

$$SNY = b_0 + b_1 GDY + b_2 (NBD \cdot GDY) \tag{17}$$

In other words, the coefficient of *GDY* is variable and depends on the proportion of the deficit financed by the domestic private non–bank sector.

The estimate of equation 17 using annual data is (1 455 observations):

$$\begin{gathered} SNY = -0.332(GDY) + 0.177(NBD \cdot GDY) \\ (-8.335) \qquad (7.972) \\ \overline{R}^2 = 0.735 \end{gathered} \tag{18}$$

Using a similar specification for growth with average values from 89 countries for which some data are available over 1979–93 gives:

$$\begin{gathered} YG = 0.039 - 0.188(GDY) + 0.021(NBD \cdot GDY) \\ (12.762) \;\; (-2.362) \qquad\qquad (3.362) \\ \overline{R}^2 = 0.188 \end{gathered} \tag{19}$$

With this, the statistical case rests in favour of voluntary domestic markets as the best alternative for financing government deficits. The evidence supports the premise that voluntary borrowing from the domestic private sector offers the least harmful way of financing any given deficit. Fry (1997) discusses the problems of developing such markets in some detail.

Saving, Growth and Financial Distortions

In their analysis of financially repressed developing economies, McKinnon (1973) and Shaw (1973) argue that financial repression — indiscriminate "distortions of financial prices including interest rates and foreign–exchange rates" — reduces "the real rate of growth and the real size of the financial system relative to non–financial magnitudes. In all cases this strategy has stopped or gravely retarded the development process" (Shaw, 1973, pp. 3–4).

Following Shaw (1973, p. 3), the analysis here uses both the real deposit rate of interest *RR* and the black market exchange rate premium *BLACK* as proxies for financial distortions. Negative real interest rates generally reflect some government–imposed distortion in domestic financial markets (Fry, 1995; Giovannini and de Melo, 1993). Because governments using financial repression as a source of revenue attempt to prevent capital outflows that would erode their tax base, black market exchange rate premia also provide an indicator of financial repression.

High positive real interest rates indicate a poorly functioning financial system in which inadequate prudential supervision and regulation enable distress borrowing to crowd out borrowing for investment. The De Gregorio–Guidotti effect discussed above could also apply to saving behaviour. Very high real interest rates reflecting increased risk and uncertainty could reduce measured national saving, particularly if the increased domestic risk encourages savers to remove their savings abroad through underinvoicing and overinvoicing. Again, the problem that both very low and very high real interest rates could deter saving is resolved by using the square of the real deposit rate; this ensures that large positive and negative values exert the same, presumably negative, effect on the saving ratio.

The empirical work reported in this section uses data from a sample of 16 developing countries — Argentina, Brazil, Chile, Egypt, India, Indonesia, Korea, Malaysia, Mexico, Nigeria, Pakistan, Philippines, Sri Lanka, Thailand, Turkey and Venezuela — for 1970–88. The regression method used throughout is iterative three–stage least squares which is, asymptotically, full–information maximum likelihood (Johnston, 1984, pp. 486–492). The 16 individual country equations for saving, investment, export growth and output growth are estimated as systems of equations with cross–equation equality restrictions on all coefficients except the intercept. Hence, the estimates apply to a representative member of this sample of developing countries. The estimation technique corrects for heteroscedasticity across country equations and exploits contemporaneously correlated disturbances.

National Saving

The saving function is based on a life–cycle model (Masson, 1987)[4]. The estimate of the national saving ratio *SNY*, expressed as the ratio of national savings to GNP (both in current prices), for this sample of 16 developing countries is (297 observations):

$$
\begin{aligned}
SNY = {} & 0.289YG - 0.038BLACK - 0.006RR^2 \\
& (123.359) \quad (-39.816) \quad (-3.981) \\
& - 0.198(YG \cdot BLACK) - 0.205(YG \cdot RR^2) + 0.812SNY_{t-1} \\
& (-12.487) \quad (-5.696) \quad (748.272) \\
& R^2 = 0.861
\end{aligned}
\tag{20}
$$

It indicates that income growth *YG* increases the national saving ratio in this sample of countries — but both the black market exchange rate premium *BLACK* and the squared real interest rate *RR* not only exert negative impacts on saving through the level effect but also reduce the rate–of–growth effect as shown by the negative interaction terms. Later analysis will show that a higher black market exchange premium and a real exchange rate that diverges from zero also reduce the national saving ratio *indirectly* by reducing the output growth rate *YG*.

The analysis compares saving performance in five Pacific Basin countries (Indonesia, Korea, Malaysia, Philippines and Thailand) with that in the 11 remaining ones; it therefore tests the appropriateness of imposing a coefficient equality constraint across all the equations. Relaxing this constraint by allowing the Pacific Basin country coefficients to differ from those of the 11 remaining countries produces an *F* statistic of 0.90, well below the 95 and 99 per cent significance levels of 3.04 and 4.71 respectively. In other words, pooling is not rejected (Johnston, 1984, pp. 206–207, 553).

Investment

The investment function specified here in terms of the ratio of investment to GNP is based on the flexible accelerator model. Mario Blejer and Mohsin Khan (1984, pp. 382–383) describe some of the difficulties of estimating neo–classical investment functions for developing countries. Without data on the capital stock and the return to capital, little choice exists but to use some version of the accelerator model.

A simple specification search suggests that, for the 16 developing countries analysed here, the speed of adjustment is influenced by the real interest rate squared but not by the black market exchange rate premium. If the real deposit rate of interest is held below its free–market equilibrium level, the effective (albeit unobservable) real loan rate would rise as the real deposit rate falls. The lower the real deposit rate, the smaller the volume of saving and hence the higher the market–clearing loan rate of interest. In such a case, the real deposit rate acts as an inverse proxy for the real loan rate and has a positive impact on the investment ratio (Blejer and Khan, 1984, p. 386). In other words, changes in the real deposit rate trace out movements along the supply (saving) curve rather than along the demand (investment) curve.

In the absence of administrative ceilings, real interest rates will likely be positive; a rise in real deposit rates could occur with a leftward shift in the supply (saving) curve and a corresponding movement up the demand (investment) curve, with the resulting reduction in investment. In other words, a zero real interest rate may maximise the investment ratio. Lower real rates imply ceilings that reduce the availability of investable funds. Higher real rates signal distress borrowing not for investment but for survival, crowding out loan demand for productive investment. The real interest rate squared allows for these non–linear or regime–shift effects on investment.

The estimated investment function derived from this flexible accelerator model is (297 observations):

$$\begin{gathered} IY = 0.251YG - 1.628RR^2 + 0.692IY_{t-1} \\ (32.671)\ \ (-11.661)\ \ (43.998) \\ R^2 = 0.794 \end{gathered} \tag{21}$$

where *IY* is the ratio of gross domestic investment to GNP at current prices. Evidently, high negative or positive real interest rates do reduce the investment ratio.

Export Growth

For a small, open developing economy, export demand will likely be infinitely elastic. Therefore, export growth in this model is determined from the supply side. The first determinant of export supply, expressed as the rate of growth in exports at constant prices *XKG*, is the rate of growth in real GNP *YG* acting as the supply constraint. Since investment raises the capacity to export, the ratio of gross domestic investment to GNP at constant prices *IKY* is included as an additional supply constraint.

The basic price variable in the export equation is the real exchange rate or the relative price of exports to non–traded goods. The real exchange rate, however, is itself determined by the saving–investment balance and foreign exchange restrictions. Hence the estimate uses a *quasi* reduced–form equation, substituting the gap between national saving and domestic investment as a ratio of GNP *SIY* and the black market exchange rate premium for the real exchange rate[5]. Here the black market exchange rate premium squared yields somewhat better results than its level (290 observations):

$$\begin{gathered} XKG = 0.364(YG) + 0.179(IKY) + 0.496(SIY) - 0.224(BLACK^2) \\ (5.797)\qquad (3.756)\qquad (11.941)\qquad (-2.846) \\ R^2 = 0.153 \end{gathered} \tag{22}$$

As anticipated, the output growth rate, the investment ratio, and the saving–investment balance increase export growth, while the black market exchange rate premium exerts a negative effect.

Output Growth

Following Gershon Feder (1982), the growth rate function estimates the effect of export growth on output growth. The assumption of constant marginal returns to capital in the early development models was regarded as a serious defect for most of the 1960s and 1970s, but endogenous growth models developed since the mid–1980s provide a theoretical justification for assuming that the marginal product of capital does not diminish for the economy as a whole.

Although the marginal product of capital may not suffer diminishing returns, its value could be affected by financial distortions. As the World Bank (1989, pp. 29–31) points out:

> "Historically, the quality of investment has been at least as important for growth as the quantity. Although the fastest–growing countries had higher rates of investment than the others, empirical studies generally find that less than half the growth in output is attributable to increases in labour and capital. Higher productivity explains the rest. Faster growth, more investment, and greater financial depth all come partly from higher saving. In its own right, however, greater financial depth also contributes to growth by improving the productivity of investment."

An increasing body of evidence now suggests that qualitative differences in investment are far more important than quantitative differences in explaining different output growth rates across countries (Fry, 1995, Ch. 8; King and Levine, 1993*a*, 1993*b*; Roubini and Sala–i–Martin, 1992). These productivity differentials may be caused by trade and financial distortions imposed on the economy by government policy (Dollar, 1992; Roubini and Sala–i–Martin, 1991). Therefore, the estimate interacts both the black market exchange rate premium *BLACK* and the domestic real interest rate *RD* squared with the investment ratio. In this case, the initial specification search indicated that the level rather than the square of the black market exchange rate premium produced better results.

The point made by De Gregorio and Guidotti (1993) that very high real interest rates can be as destructive as very low real rates again holds up well in this growth rate estimate. Initially, the relationship between the output growth rate *YG*, the investment ratio *IKY*, the real rate of interest *RR*, and the rate of growth in exports at constant prices *XKG* appears in an equation of the form:

$$YG = \beta_1(IKY) + \beta_2\left[IKY \cdot (RR + \beta_3) \cdot (RR + \beta_3)\right] + \beta_4(XKG) \qquad (23)$$

Since the parameter $ß_3$ was not significantly different from zero, although its negative value implies that growth is maximised at some positive real interest rate, it was dropped from the estimate reported here. The three–stage iterative least squares estimate is (290 observations):

$$YG = \underset{(16.850)}{0.226(IKY)} - \underset{(-9.786)}{0.999(KHY \cdot BLACK)} - \underset{(-11.389)}{0.354(IKY \cdot RR^2)} + \underset{(19.691)}{0.098(XKG)} \qquad (24)$$

$$R^2 = 0.202$$

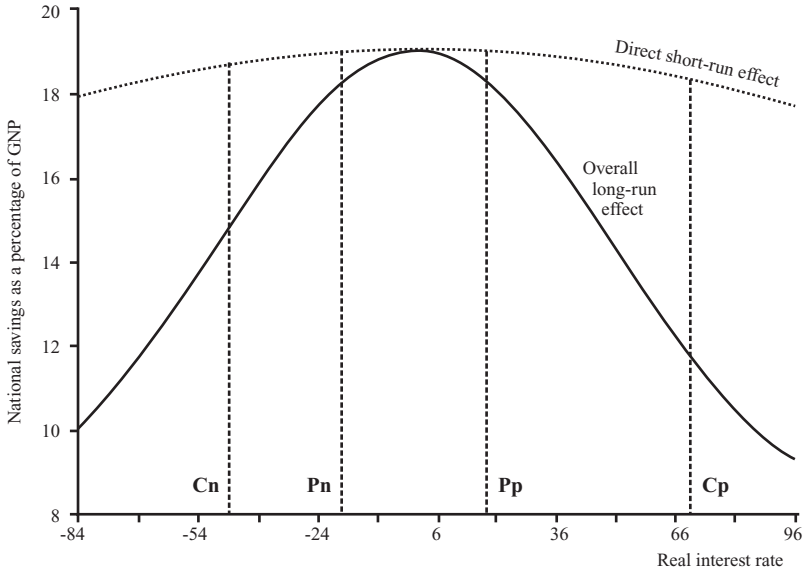
Direct and Indirect Effects of Financial Distortions on National Saving Ratios and Output Growth Rates in the Pacific Basin and Other Developing Regions

One can now examine both the direct short–run and overall long–run effects of financial distortions on saving and output growth by comparing the estimated variations in the saving ratio and output growth rate caused by changes in the financial distortion variables in equations 20 and 24 with the estimated variations caused by changes in the financial distortion variables in the system of equations consisting of equations 20, 21, 22 and 24. The simulated changes in the financial distortion variables are confined to the observed range recorded for this country sample.

The five Pacific Basin developing market economies (Indonesia, Korea, Malaysia, Philippines and Thailand) in this sample experienced substantially less financial distortion than did the 11 remaining countries. Therefore, the range of values for each country group in terms of standard deviations from respective mean values is indicated. For the real interest rate, standard deviations are calculated separately for negative and non–negative rates.

Figure 7 illustrates both the direct effect from equation 20 and the overall effect from the joint simulation of equations 20, 21, 22 and 24 of a rising real interest rate on the national saving ratio. The simultaneous–equation model used to estimate the overall effect also contains identities defining the saving–investment gap and the equivalence of the nominal and real investment ratios. Figure 7 is produced using the mean values of all the explanatory variables with the exception of the real deposit rate of interest. The mean value of the real deposit rate for the entire country sample is zero, with a standard deviation of 23 per cent. Its minimum value is –83 per cent and its maximum value 221 per cent. Figure 7 shows that the relationship between the real interest rate and the national saving ratio resembles an inverted *U*. Both very low and very high real interest rates reduce national saving mainly through the effects of these interest rates on output growth.

Figure 7. **Effects of Real Interest Rates on National Saving Ratios**



The line P_n denotes two standard deviations below the mean of all negative interest rates in the Pacific Basin economies, C_n denotes two standard deviations below the mean of all negative interest rates in the remaining 11 countries (the control group), P_p denotes two standard deviations above the mean of all zero or positive interest rates in the Pacific Basin economies, while C_p denotes two standard deviations above the mean of all zero or positive interest rates in the control group countries. Evidently, real interest rates deviated from their saving–maximising level far more in the control group countries than they did in the Pacific Basin economies.

Figure 8 illustrates both the direct effect from equation 24 and the overall effect from the joint simulation of equations 20, 21, 22 and 24 of a rising real interest rate on output growth. It shows that both very low and very high real interest rates also reduce output growth through their effects on investment productivity. Again, real interest rates deviated from their growth–maximising level far more in the control group countries than they did in the Pacific Basin economies. In contrast to the considerable differences between direct and overall effects of real interest rates on national saving ratios, Figure 8 indicates that the direct effects of real interest rates on growth rates are very similar to their overall effects.

Figure 8. **Effects of Real Interest Rates on Growth Rates**

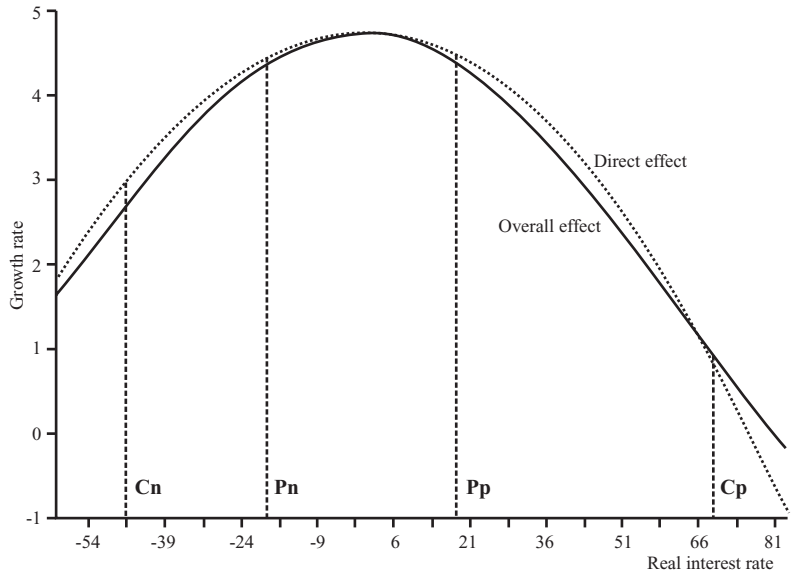
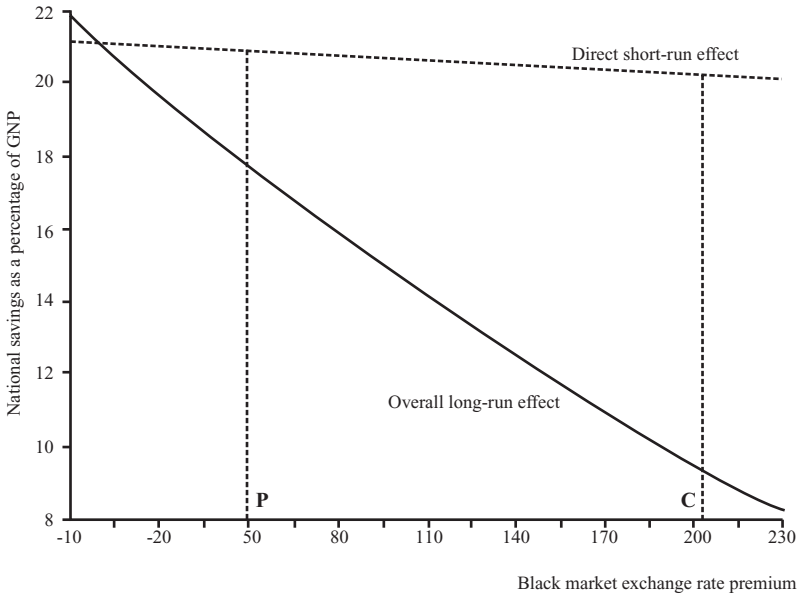


Figure 9 shows both the direct effect from equation 20 and the overall effect from the joint simulation of equations 20, 21, 22 and 24 of a rising black market foreign exchange rate premium on the national saving ratio. The national saving ratio falls as the black market exchange rate premium rises, again mainly through the effect of the black market foreign exchange rate premium on output growth. For the complete country sample, the mean value of the black market exchange rate premium is 31 per cent with a standard deviation of 63 per cent. Its minimum value is –10 per cent and its maximum value is 639 per cent.

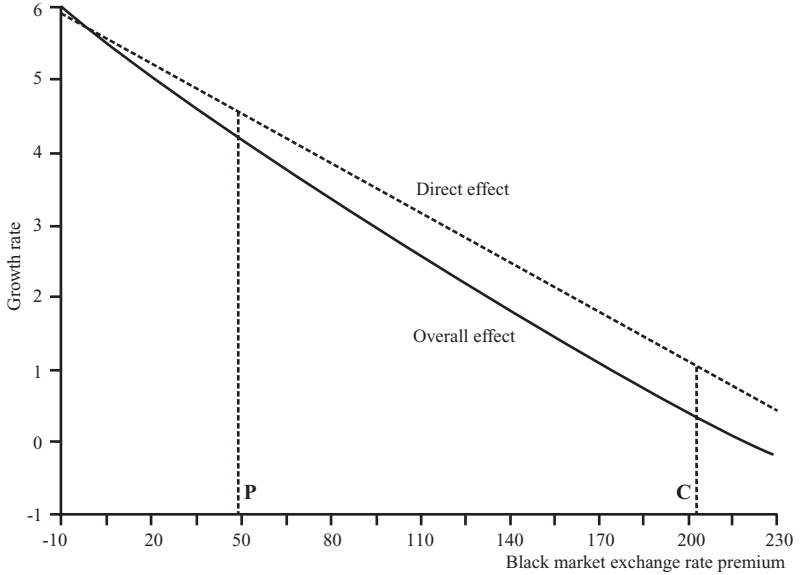
Figure 9. **Effects of Black Market Premia on National Saving Ratios**



The line *P* denotes two standard deviations above the mean of all zero or positive black market exchange rate premia in the Pacific Basin economies, while *C* denotes two standard deviations above the mean of all zero or positive black market exchange rate premia in the control group of countries. Evidently, black market exchange rate premia tended to be considerably higher in the control group than they were in the Pacific Basin economies. The indirect effects of financial distortions on national saving ratios are far greater than the direct effects.

Figure 10 shows the direct effect from equation 24 and the overall effect from the joint simulation of equations 20, 21, 22 and 24 of a rising black market exchange rate premium on output growth. Evidently, the growth rate falls as the black market exchange rate premium rises.

Figure 10. **Effects of Black Market Premia on Growth Rates**



Over 1970–88, the national saving ratio in the five Pacific Basin countries averaged 23.8 per cent compared with 16.0 per cent in the 11 countries of the control group, while the continuously compounded output growth rate in the Pacific Basin countries averaged 6.2 per cent compared with 3.9 per cent in the control group. Over the same period, the black market exchange rate premium averaged 6.2 per cent in the Pacific Basin countries compared with 42.6 per cent in the control group, while the square of the real interest rate was ten times greater in the control group than it was in the Pacific Basin.

The overall effects of both financial distortion variables are estimated by simulating the model consisting of equations 20, 21, 22 and 24, together with identities defining the saving–investment gap and the equivalence of the nominal and real investment ratios. These simulations indicate that differences in the average values of the financial distortion variables in each country group account for 3.7 points of the 7.8 percentage point difference in the national saving ratios between the Pacific Basin

and control group countries and for 1.7 points of the 2.3 percentage point difference in their output growth rates. In other words, these two financial distortions explain 50 per cent of the difference in saving ratios and 75 per cent of the difference in output growth rates between these two country groups.

Some Policy Conclusions

Many newly emerging markets need to increase resources available for investment. The first section of this paper showed that government deficits reduce national saving and growth. Furthermore, greater reliance on inflationary finance, financial repression and excessive foreign borrowing as ways of financing any given deficit reduces saving and impedes economic development even more. Although government deficits generally do not promote saving or long–run economic growth under any circumstances, financing them through voluntary private sector purchases of government debt appears to reduce the damaging effects of any given deficit.

The analysis then went on to show that a reasonably large part of the above–average economic performance of the Pacific Basin developing market economies arose from economic policies that ensured negligible levels of financial distortions, as measured by both the real rate of interest and the black market exchange rate premium. The macroeconomic policies that avoided seriously distorted financial and foreign exchange markets have stimulated investment and export growth. High investment and rapid export growth accelerated output growth. Higher output growth rates and undistorted financial and foreign exchange markets raised both saving and investment ratios. The evidence suggests that financial conditions fostered by government policies played an important role in producing the virtuous circles of high saving, investment, output growth and export growth found in the Pacific Basin.

The favourable investment climates in the developing economies of the Pacific Basin have ensured readily available FDI flows without the need for governments to discriminate in favour of this particular form of investment finance. Hence, these economies have avoided the two major pitfalls of FDI, namely, low or negative productivity caused by distortions in the economy and expensive discriminatory incentives provided in the mistaken belief that FDI brings externalities.

Recently, Morris Goldstein, Donald Mathieson, and Timothy Lane (1991, p. 43) have noted the links between macroeconomic policies that promote domestic saving and capital repatriation on the one hand, and a successful experience with FDI on the other:

> "At a minimum, domestic fiscal, monetary, exchange rate, and financial policies must be designed to create stable domestic economic and financial market conditions, to provide domestic residents with clear incentives to hold their savings in domestic financial claims, and to ensure that available domestic and foreign savings are used to support productive investment. Stable economic conditions are also important for encouraging foreign direct investment."

It comes as no surprise, therefore, to find a strong, positive correlation between the ratio of domestically financed investment to GNP and the ratio of FDI to GNP.

Indeed, inflows of foreign direct and portfolio investment provide indicators of development performance and potential. Policies aimed directly at stimulating these forms of capital inflows appear ineffective or produce effects opposite to those desired. The evidence suggests overwhelmingly that policies that promote domestic investment and growth will most likely stimulate private sector capital inflows in all forms. In summarising findings similar to those of Venkataraman Balasubramanyam (1984), Jamuna Agarwal, Andrea Gubitz and Peter Nunnenkamp (1991, p. 128) conclude:

> "[T]he effectiveness of tax and tariff exemptions as well as related privileges for FDI, some of which are very costly for the host countries, is uncertain at best. They may even result in a vicious circle if privileges granted to foreign investors give rise to hostile feelings against FDI in the recipient countries. The consequences may be a new wave of regulations, intensified efforts to circumvent the restrictions, and finally the retreat of foreign investors. It appears more promising to adhere to the rule: 'what is good policy for domestic investors is also good for foreign investors', by creating a stable and favourable general framework for investment. Ad hoc interventions should be kept to the minimum. It is not only the rules and regulations that matter, but also how they are applied in practice. The approval procedure should be fast and transparent as it is a crucial element in the investment decision of foreign companies."

Recent evidence is certainly consistent with this conclusion (Fry, 1993).

To mobilise both domestic and foreign resources effectively and efficiently for the task of financing economic reform, the following key guidelines derive from the material presented above:

— If possible, reduce the government deficit;

— At the least, reduce the government deficit so that the inflation tax and financial repression can be abandoned without generating an unsustainable and explosive deficit;

— Pursue macroeconomic policies and sound prudential regulation and supervision of the banking system to avoid financial distortions of both interest and exchange rates;

— Ensure that government and government–guaranteed foreign debt do not exceed 50 per cent of GNP;

— Implement policies that improve the overall investment climate and facilitate foreign direct investment that then seeks to participate in the economy's growth.

Notes

1. My thanks go first and foremost to Yoon Je Cho for kindly presenting this paper on my behalf. I am also most grateful to Yoon Je Cho, Chung Lee and Augustine Tan for comments on an earlier draft. Research reported in the third section was supported by the Economic and Social Research Council under its Research Programme on Pacific Asia, grant L324253010.

2. The world real interest rate is the London interbank offered rate on US dollar deposits adjusted for the percentage change in the US GDP deflator.

3. All data used in this section are taken from IMF, *International Financial Statistics*, CD-ROM, March 1996*b*, and World Bank, *World Data 1995*, CD-ROM, September 1995.

4. Paul Masson, Tamin Bayoumi and Hossein Samiei (1995) provide a recent comprehensive survey of both theoretical and empirical issues relating to saving behaviour.

5. An estimate using the natural logarithm of the real exchange rate produces virtually the same results.

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Employment Generation and Poverty Alleviation in Developing Economies

Gary S. Fields

We know well that the East Asian economies have achieved higher economic growth rates than those in any other region of the world[1] and that production for world markets has featured as a hallmark of the East Asian successes. This paper has three purposes: first, to present comparative data showing that the rates at which employment opportunities improve and poverty is reduced mirror countries' differential growth experiences; second, to examine differences in labour market institutions, demonstrating that those in East Asia have similarities more likely to lead to higher output performance and shared improvements in living conditions; and third, to present a model analysing the synergy between countries' choices of trade and labour market policies.

The Comparative Record

Table 1 displays changing labour market conditions in a number of East Asian and Latin American economies. The extraordinary improvements in employment conditions that have taken place in the East Asian economies stand out. Consistent with the famous model of Lewis (1954) and Fei and Ranis (1964), the data for each economy exhibit two phases: *i)* falling unemployment with at best modest increases in real earnings levels, followed by *ii)* essentially full employment with rapidly rising real earnings. The earnings increases are quite remarkable: real earnings increased by a factor of four in Hong Kong in 30 years, by a factor of six in Korea in 25 years, and by a factor of eight in Chinese Taipei in 30 years — in each case, with unemployment rates in the 2–4 per cent range[2].

Table 1. **Changing Wages and Unemployment in East Asia and Latin America**
(Index numbers and percentages)

East Asia			Latin America		
	Hong Kong			***Bolivia***	
Year	Index of Real Wages	Unemployment	Year	Index of Real Wages	Unemployment
1948	100	n.a.	1980	181.8	7.5
1960/61	105	1.7	1985	100	5.7
1965	157	n.a.	1987	76.4	5.9
1970/71	167	4.4			
1975/76	194	4.3			
1980	253	3.7		***Chile***	
1985	301	3.8	Year	Index of Real Wages	Unemployment
1990	405	1.7	1978	82	14
			1984	100	14
			1990	105.2	6
	Korea				
Year	Index of Real Earnings	Unemployment			
1963	n.a.	8.2		***Mexico***	
1966/67	100	6.2	Year	Index of Real Wages	Unemployment
1971/72	169	4.5	1980	129.4	4.7
1976	n.a.	3.9	1984	100	5.6
1980/81	306	4.1	1990	103.3	2.8
1986	421	3.8			
1990	660	2.4			
				Brazil	
			Year	Index of Real Earnings	Unemployment
	Singapore		1981	100	4.3
	Index of Average Real		1983	60.3	4.9
Year	Monthly Income per Worker	Unemployment	1989	68.3	3
1966	100	9.1 (1965)			
1975	100	4.8 (1977)			
1980	120	3.5		***Costa Rica***	
1985	176	4.1	Year	Index of Average Monthly Income	Unemployment
1990	216	2	1976	79.4	6.2
			1979	104.2	4.8
			1982	60.2	9.4
	Chinese Taipei		1986	94	6.2
	Index of Real				
Year	Manufacturing Earnings	Unemployment			
1954	100	6.3 (1955)		***Venezuela***	
1960	102	4.3 (1963)	Year	Index of Real Earnings	Unemployment
1970	183	1.5 (1972)	1977	89.8	4.6
1979	400	1.3 (1981)	1980	100	5.7
1985	518	2.9	1984	68	13.4
1990	810	1.7	1988	61.9	6.9
			1992	47.4	7.1

Sources: For Hong Kong, Korea, Singapore and Chinese Taipei: Asian Development Bank (1994).
For Bolivia, Chile, and Mexico: World Bank (1995).
For Brazil, Costa Rica, and Venezuela: Fields and Newton (1997).

Critics of the East Asian model of economic growth sometimes point to labour repression, the so–called "dark underside" of the East Asian miracle[3]. Yet despite the repressive measures that were sometimes in effect (and still are in some cases), labour participated fully in the rapid economic growth that took place. Table 2 compares the growth in real per capita national income with that of real earnings. In Hong Kong, Korea and Singapore, national income and labour earnings grew at essentially the same rate, while in Chinese Taipei earnings grew even faster than national income. Far from being left behind, workers in East Asia shared proportionately in their countries' exceptionally fast growth.

Table 2. **Growth in National Income and Earnings in Four Newly Industrialising Economies in East Asia, 1980-90**
(Percentages)

Economy	Growth in Real GNP or GDP per capita	Growth in Real Earnings
Hong Kong	64.2	60.0
Korea	121.8	115.8
Singapore	77.5	79.8
Chinese Taipei	88.0	102.7

Source: Fields (1994), Table 1.

Shared growth of so large a magnitude should produce a reduction in poverty rates. Data using country–specific poverty lines since 1980 show that this is indeed the case. In Chinese Taipei, the poverty rate (gauged by the poverty headcount ratio) fell from 47 per cent in 1980 to 15 per cent in 1992 (source: author's calculations from data in Republic of China, *Statistical Yearbook of the Republic of China*, various years). In Korea, the percentage of workers below a constant real low earnings line was 62.6 per cent in 1980 and just 10.3 per cent in 1991 (Yoo, 1995). The poverty rate fell over a five–year period from 28.5 per cent to 18.3 per cent in Hong Kong and from 31.2 per cent to 26.1 per cent in Singapore (Fields, 1994).

During the last several years, the United Nations has made extensive use of a measure which combines countries' records on education, life expectancy, and national income into a single Human Development Index (HDI). Table 3 presents these data for various regions of the world and for the newly industrialising economies of East Asia (excluding Chinese Taipei, which the United Nations refuses to recognise). These data show *i)* the increases in the HDI were 50–100 per cent greater in the Asian NIEs than in the world as a whole and, consequently *ii)* the HDI levels attained by Hong Kong, Korea, and Singapore place them on a par with the industrial countries.

Table 3. **Levels and Changes in United Nations Human Development Index**

	Level, 1960	Level, 1992	Change, 1960-1992
Various country aggregates:			
All developing countries	0.260	0.541	0.281
Least developed countries	0.165	0.307	0.142
Industrial countries	0.799	0.918	0.119
World	0.392	0.605	0.213
East Asian NIEs:			
Hong Kong	0.561	0.875	0.314
Singapore	0.519	0.836	0.317
Korea	0.398	0.859	0.461

Source: United Nations (1994), Table 5.5 and Annex Table A5.3.

By contrast, Latin America has a quite dismal record, not only absolutely but relative to East Asia, with the 1980s correctly characterised as the "lost decade" in that region. Macroeconomic growth was essentially nil: the region's economies grew by just 0.9 per cent per year in the 1980s, but after adjusting for population increases, real per capita GDP fell by 1.2 per cent per year (Inter–American Development Bank, 1991, Table B–1). The lack of macroeconomic growth in some Latin American countries and the actual worsening of economic conditions in others manifested itself at times in disturbingly high unemployment rates (14 per cent in Chile, 13 per cent in Venezuela) and at other times in shocking declines in real wages or earnings (20 per cent in Mexico, 32 per cent in Brazil, 47 per cent in Venezuela, and 58 per cent in Bolivia). Poverty stagnated or worsened under such conditions: poverty rates doubled in Venezuela, stagnated in Colombia and Brazil, and fell modestly in Costa Rica (Morley, 1994, Table 6).

In sum, labour market conditions improved and poverty fell sharply in East Asia, while the opposite held true for Latin America, principally, of course, because the East Asian economies grew much more rapidly. While many reasons have been cited for this differential growth experience — see, for instance, the World Bank's "East Asian miracle" study (1993) and various critiques of it[4] — the balance of this paper focuses on one particular factor, namely the workings of the labour market. The following section presents and analyses ways in which the labour market institutions in East Asia differ from those in most other regions of the world, while the third section presents a model showing how a country's labour market and trade regimes may interact with one another to affect possibilities for economic development.

Differences in Labour Market Institutions

Empirical Differences

In general, East Asian wages reflect to a much greater degree than those in other regions of the developing world the forces of supply and demand in labour markets. Consider the following:

Minimum wages aim to assure workers an "adequate" standard of living. Long on the books throughout most of the developing world (Starr, 1981), they have little importance in East Asia. Korea introduced a minimum wage system only in 1988 and has set the minimum wage level so that it proves to be a binding constraint for only a small fraction of Korean workers (Park, 1992). Although Chinese Taipei has had a minimum wage law in force for decades, no company has ever been fined for violating the law (Chang, 1989).

Trade unions are often encouraged by government policy as a means of entitling workers to a "just" share of the fruits of their labour. Unions have raised the wages of their members by as much as 150 per cent in Jamaica, 31 per cent in Ghana, 24 per cent in South Africa, and 20 per cent in Malaysia (Tidrick, 1975; World Bank, 1995, Table 12.2). By contrast, in Korea and Chinese Taipei, unions are repressed and the union wage premium is at most 2–3 per cent (Lin, 1989; Park, 1991; Yoo, 1995).

Public sector pay policies often result in substantially higher wages for government workers than for their private sector counterparts. Costa Rica exemplifies this and as a result, "everybody" in Costa Rica tries to work for the government (Gindling, 1991). In East Asia, the public sector pays what is needed to compete with the private sector — neither more nor less.

Multinational corporations sometimes pay above–market wages in sub–Saharan Africa and elsewhere (Berg, 1969). Although this occurs partly for efficiency wage reasons (Stiglitz, 1974, 1976), it also happens because some governments have "encouraged" them to do so by not so subtly threatening expulsion or expropriation if they do not. In Korea and other East Asian countries, wages and working conditions are the same in foreign and domestic firms (ILO, 1996).

Finally, *labour codes* may regulate hiring and firing, impose payroll taxes on firms and mandate that employers provide certain benefits to their workers. Panama had such a labour code, which raised labour costs by an estimated 90 per cent (Spinanger, 1985) before it was finally abandoned as unsustainable. Likewise, Bolivian employment legislation raises labour costs by an estimated 90–110 per cent (Bravo, 1995). Companies in India and Zimbabwe may not dismiss workers, resulting in artificially high employment levels and artificially low economic efficiency (Fallon and Lucas, 1991, 1993). In East Asia, employers also face labour codes (for instance, severance payments must be made to laid–off workers), but with very much lower costs.

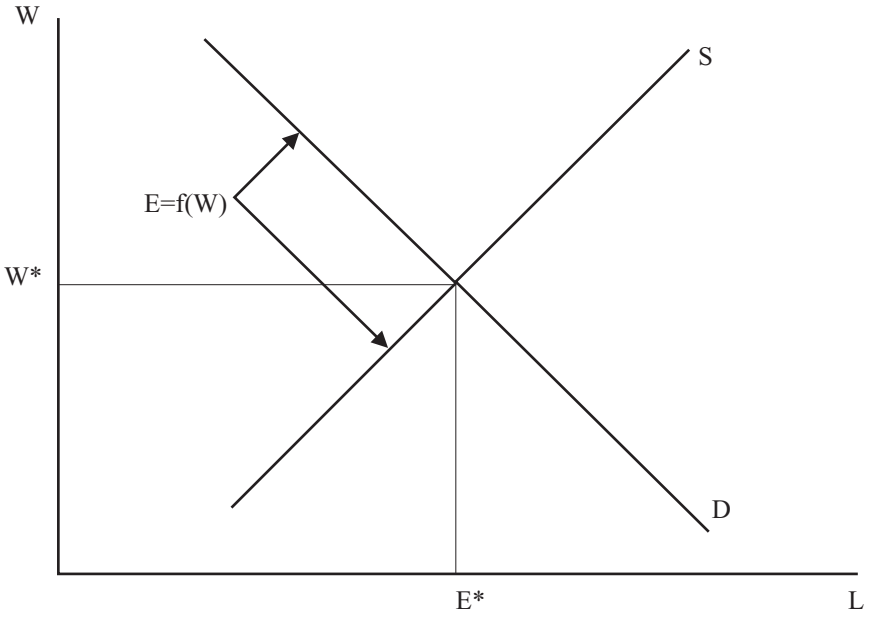
These labour market interventions, aimed at raising earnings and reducing poverty, mean well and do indeed benefit workers fortunate enough to work in covered sectors of the economy. Nevertheless, they appear to have had adverse employment and efficiency effects and to have contributed to the informalisation of the economy, as employers evaded the regulations by not engaging workers as regular employees or by not even appearing as official companies (De Soto, 1989).

It is an empirical question as to which worked better to raise workers' standards of living and thereby reduce poverty: the direct approach (pushing wages and benefits up through public policy intervention) or the indirect approach (fostering economic growth of a type that would cause wages and other benefits to be pulled up by the forces of supply and demand in labour markets). Judging from the record, the indirect approach may have something to commend it. Economic theory suggests that this pattern is by no means accidental. Several heuristic models can show it.

Theoretical Explanations

The three models that follow demonstrate how market wage determination should lead to higher levels of economic activity than wage levels set artificially above or below the market–clearing level. *Model 1* consists of a labour market with a single common wage. As depicted in Figure 1, given an upward–sloping labour supply curve (S) and a downward–sloping labour demand curve (D), W* denotes the market–clearing wage and L* the market–clearing employment level.

Figure 1. **Non–market Clearing Wages Reduce Employment**



Consider what would happen if the wage were to be set anywhere above W*. Employers would move up their labour demand curves and employment would fall. Accordingly, less output would be produced and the economy would operate at a sub–optimal level. While the dynamics would have to be fully worked out, it is likely that the economic growth rate in such an economy would be lower as well.

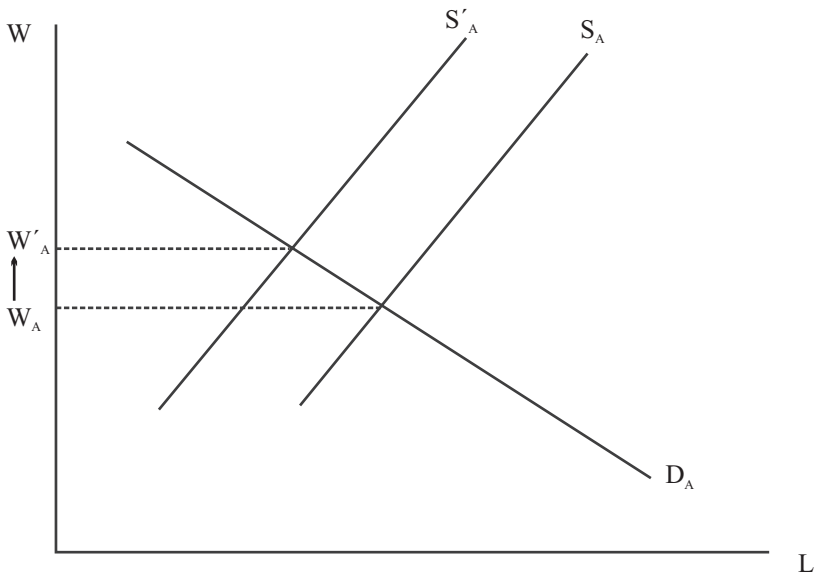
The hazards of a wage higher than one which clears the market are well understood in East Asia. Less well appreciated are those of a wage below the market–clearing level, such as Singapore tried for a number of years in the 1970s[5]. Any wage rate below W* would cause employers to want to move down their labour demand curves and workers to move down their labour supply curves. Labour supply, of course, provides the binding constraint: fewer workers appear than employers want to hire at such wages. With less labour supplied, there is less employment, hence less output, hence slower economic growth.

This analysis shows that in a single labour market model, the wage level which clears the market maximises employment and hence output. The E = f(W) locus in Figure 1 shows that the further the wage is from the market–clearing level W*, the further is employment from the maximum possible (E*). The limited role of segmenting factors in East Asian labour markets may furnish part of the explanation for why their growth rates and employment levels have been so high for so long.

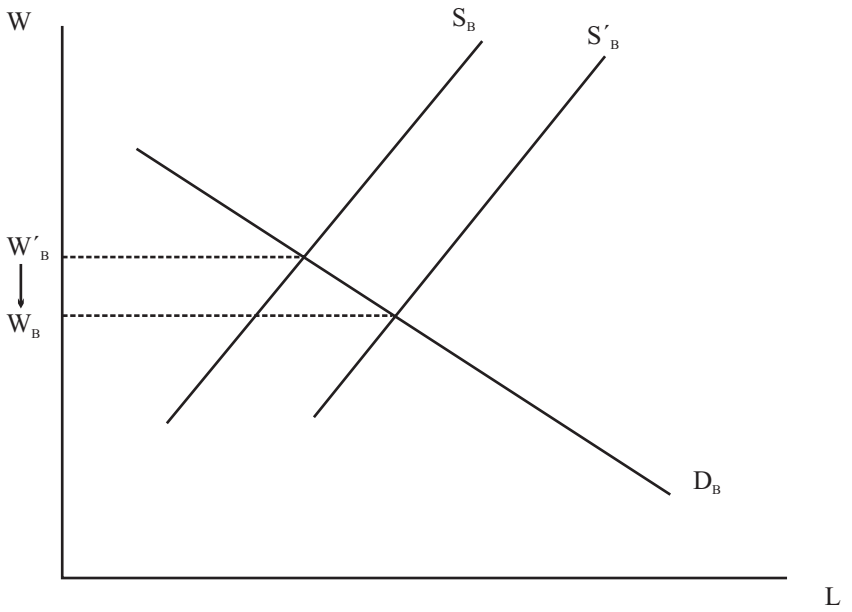
Model 2 resembles Model 1 except that the minimum wage covers only part of the economy. In this model, some sectors face a minimum wage or other institutional wage–setting force and some do not. As shown in Figure 2, the higher wage in the covered sectors than in the non–covered sectors implies that the covered sectors face unlimited supplies of labour within the relevant range. The higher the minimum wage in the covered sectors, the smaller will be employment there. Assuming that workers not employed in the covered sectors take up employment in the non–covered sectors, an increase in the minimum wage in the covered sectors will increase the crowding of labour into the non–covered sectors[6]. This crowding results not only in lower wages in the non–covered sectors but also in greater dead–weight losses *à la* Harberger, and therefore lower aggregate output.

Figure 2. **In a Crowding Model, a Higher Wage in Sector A Reduces Employment in That Sector, Crowds Workers into Sector B and Lowers the Sector B Wage**

Labour Market Consequence of Crowding Workers Out of Sector A

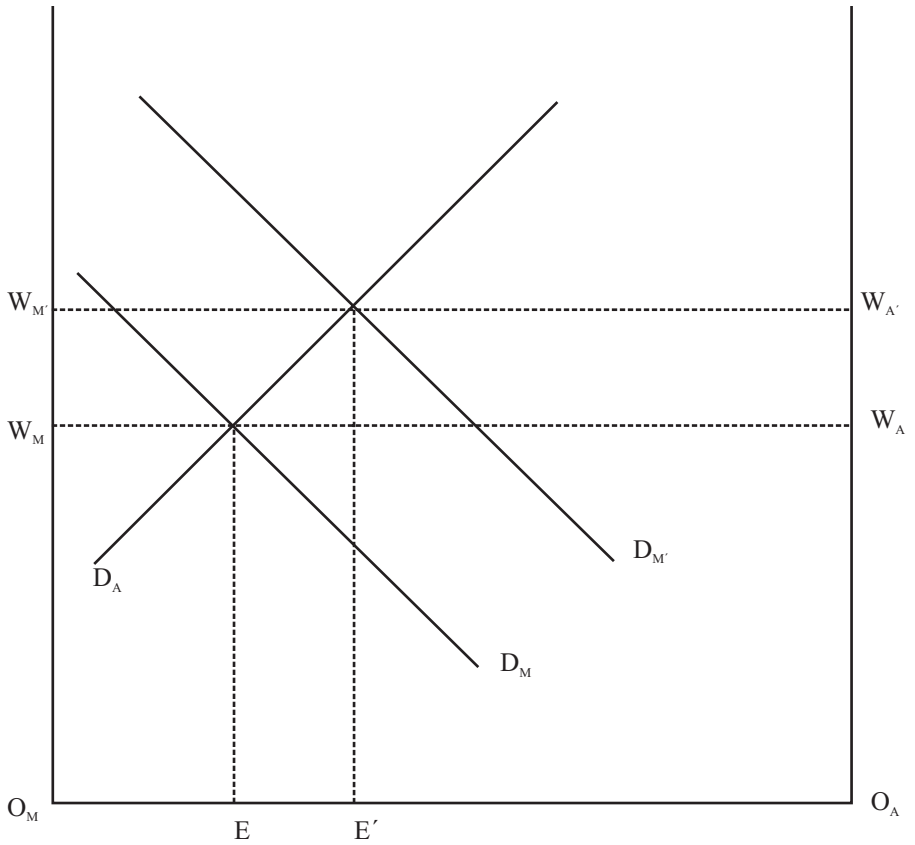


Labour Market Consequence of Crowding Workers into Sector B



Model 3 offers a happier scenario. It shows how economic growth in one part of an economy leads to higher wages for all workers. Suppose for ease of analysis that the economy has two sectors, here termed "manufacturing" and "agriculture", and that the labour market is integrated in the sense that the same wage prevails in both sectors for a given type of worker — a realistic enough stylisation of the East Asian situation. Figure 3 depicts what happens when economic growth takes place in one sector, manufacturing. The original demand for labour curve in the manufacturing sector (D_M) is downward–sloping relative to origin O_M; likewise, the original demand for labour curve in the agricultural sector (D_A) is downward–sloping relative to origin O_A. The distance O_MO_A represents the total labour supply. If the standard equilibrating forces in labour markets operate freely, as in East Asia, wages would equalise across the two sectors at level W* (=W_M). At this wage, O_ME workers would be demanded in the manufacturing sector, O_AE workers in the agricultural sector, and total labour demand in the two sectors combined would exactly equal the total labour supplied in the economy.

Figure 3. **In an Integrated Labour Market, Growth in One Sector Raises Wages in All Sectors**



Now suppose that economic growth takes place in the manufacturing sector. Because manufacturing firms need more workers to produce the extra output, the labour demand curve in the manufacturing sector shifts rightward to D_M'. Assuming no change in the agricultural product market, agricultural employers' demand for labour curve would remain stationary at D_A. The labour market is now in disequilibrium because at the original wage W* more labour is demanded than supplied. To resolve this disequilibrium, manufacturing employers raise wages to retain existing workers and attract new ones, and agricultural employers raise wages to prevent all their workers from leaving. The labour market then equilibrates at a new common wage $W' > W^*$. Because of the sector–specific shift in labour demand, the manufacturing sector has more workers than before (O_ME' rather than O_ME) and agriculture fewer (O_AE' rather than O_AE).

This analysis identifies three groups of workers: *i)* those who had been working in manufacturing and now earn higher wages than before; *ii)* those drawn by higher wages into manufacturing from agriculture; and *iii)* those who remain in agriculture and earn more than previously. In this way, economic growth in a country's export sector can benefit all workers: those who produce manufactured goods and those who produce agricultural goods.

East Asia, of course, produces manufactured goods largely for export, but not agricultural goods. The preceding discussion therefore suggests the possibility that market wage determination may facilitate not only widespread earnings gains for a country's people but expansion of exports and hence economic growth as well. The next model shows how trade policy and labour market policy may interact with each other in precisely this way.

A Model of Interactions between Trade Policy and Labour Market Policy

Policy Options

Assume an economy with two goods: a domestic good *D* and an export good *X*. Self–employed producers make the domestic good. The export good may or may not be produced in positive quantity but if it is, production occurs in an export firm facing increasing marginal costs.

Suppose the economy is controlled by a "planner" who can choose the country's trade policy (*T*). Let there be two trade policy options:

i) *T=X*: In this case, the planner adopts a policy of export promotion. He has many possible ways of doing this — by adjusting exchange rates, tariffs, taxes, or subsidies. The specific policy option considered here creates the resources to enable exports, for example by building a harbour, constructing an export–processing zone or opening a commercial office abroad. In the model below, *T=X* is a necessary condition for exporting; it could not take place, for instance, without a harbour.

ii) $T=\sim X$: In this case, the planner elects not to promote exports. He may do this by not developing domestic infrastructure, by imposing a prohibitive export duty, or by creating bad external relations. Regardless of the method chosen, $T=\sim X$ implies no export activity.

The planner makes his choice under two alternative labour market regimes:

a) $L=M$: In this case, the planner faces market–determined wages. Hence, the wages in the two sectors, W_X and W_D, are equal.

Production costs are lower under $L=M$ than under:

b) $L=\sim M$: In this regime, the planner faces non–market–determined wages in the export sector, hence a dualistic wage structure, for reasons such as those considered in the section above.

This model asks the question: using the national income criterion, how do the two trade policies (export promotion or its absence) compare in the two labour market regimes (market or non–market wages)? As developed below it demonstrates the possibility that export promotion is superior to inaction when wages in the export sector are market–determined but not when they are above market–clearing levels.

Specific Relationships of the Model

Production Functions

Output in the domestic sector (D) is produced with one input, labour, according to the relation $Q_D=q_D L_D$. This is a constant returns technology, as might pertain to a land–abundant economy in which anyone who wishes to till the land may do so and grow q_D units of crop per period.

The export sector (X) uses two inputs: labour (L_X) and an intermediate good (I). Write the production function as $Q_X=f(L_X)I$. Regarding the f component, labour is assumed to be essential to production, and its output is subject to diminishing returns: $f' > 0$, $f'' < 0$, $f(0) = 0$. The intermediate good (e.g. a harbour) also is essential to export production; I=1 if it is available, I=0 otherwise.

Product Prices

The domestic sector's product price is normalised to equal 1. In the export sector, assume the country is small in the world economy, so that the world market determines the product price (neglecting transport costs). Denote this price by P_X.

Wages

The wage in the domestic sector, W_D, equals average product, which also equals marginal product q_D. This wage is market–determined and, in a self–employment economy, clears the market.

The wage in the export sector, W_X, depends on the labour market regime. Under the regime of market–determined wages ($L=M$), $W_X=W_D$. In the non–market regime ($L=\sim M$), W_X is set rigidly at a level $\overline{W}_X > W_D$.

Employment and Unemployment

The total labour force $\overline{L}$ is the sum of export sector employment (L_X), domestic sector employment (L_D) and unemployment (L_U). The employer in the export sector pays a wage at least as high as in the domestic sector. At that wage, he faces an unlimited supply of labour. He demands labour until the point where value of marginal product equals the wage, $f'(L_X)P_X = W_X$, provided the two can in fact be equated at some positive employment level. The division of the labour force between domestic goods production and unemployment is analysed below.

Fixed Costs of Exporting and the Intermediate Good

The choice of an export–oriented trade policy obligates the planner to provide an intermediate good (I) such as a harbour essential to export production. The intermediate good, I, is a quasi–fixed cost of exporting in the sense that the cost of producing it, F, is incurred if the export–oriented trade strategy ($T=X$) is adopted, but the cost may be avoided if it is decided not to export ($T=\sim X$).

The Social Profitability of Exporting

Exporting is socially profitable if it generates revenue in excess of costs. Revenue equals P_XQ_X. The costs are the direct costs F and the foregone output from the domestic sector, $q_D(L_X + L_U)$. Hence, exporting is socially profitable if the following expression is strictly positive:

$$\xi = P_XQ_X - F - q_D(L_X + L_U) \qquad (1)$$

The Private Profitability of Exporting

For the export firm to operate, it must earn a profit, π. Therefore its revenues must at least equal its expenditures, i.e. private profits

$$\pi = P_XQ_X - \overline{W}_X L_X \qquad (2)$$

must be non–negative. The firm will earn zero profits if it decides not to produce, which would occur when either:

a) its profit would be negative for any positive output level, or

b) the planner decides not to promote exports, and therefore some essential input like a harbour is not provided to the export firm.

Relationship between Social and Private Profitability

From (1) and (2),

$$\xi = (W_X - W_D)\, L_X + \pi - W_D L_U - F \qquad (3)$$

i.e. the social profitability of exporting is equal to the increased wages received by employed labour, plus the profit earned by the exporter, minus the loss in wages of any labour that may become unemployed, minus the fixed cost of exporting borne by the planning authority.

Results under Alternative Market Closure Rules

Consider first the social profitability of export promotion in the case where wages in the export sector are market–determined ($L=M$). In this case, $W_X=W_D$ and there will be no unemployment. Substituting $W_X=W_D$ and $L_U=0$ into (3), we find that for any $F>0$, under $L=M$, a necessary (but not sufficient) condition for socially profitable exporting is that π be greater than zero, i.e. that there be a privately profitable pair (L_X, Q_X). Assume that there exists at least one such pair[7]. Denote the maximum profit under market wage determination by π^* and the corresponding employment and output levels by L^*_X and Q^*_X. Then, when $L=M$, export promotion will increase GNP if $F < \pi^*$:

$$F < \pi^* \Longrightarrow (T = X, L = M) \succ_{GNP} (T = {\sim}X) \qquad (4)$$

Consider the alternative labour market regime whereby wages in the export sector are set at non–market clearing levels ($L={\sim}M$). Suppose that the minimum wage is set below the first worker's value of marginal product but above the wage in the domestic goods sector, $P_X f'_X(0) > \overline{W}_X > W_D$. The next two models analyse this case, for efficient on–the–job search (Model 4) and inefficient on–the–job search (Model 5). In both of these models, export promotion is advantageous under market–clearing wages but not under non–market clearing wages.

Model 4: Assume there is efficient on–the–job search, i.e. any worker not employed in the high–wage export sector can search equally well while at work in the domestic goods sector at the lower wage W_D or while unemployed (Fields, 1975). No one would search while unemployed under such conditions. Suppose that some positive production level remains privately profitable under the minimum wage $\overline{W}_X$. Let $\tilde{L}_X$, $\tilde{Q}_X$, and $\tilde{\pi}$ denote the profit–maximising levels of employment, output, and profit in the export sector under $\overline{W}_X$. By (3), when $L_U = 0$, the social profitability of exporting under non–market wage determination, $\tilde{\xi}$, is

$$\tilde{\xi} = \tilde{\pi} + (\overline{W}_X - W_D)\, \tilde{L}_X - F \qquad (5)$$

If F is sufficiently large, the social profitability of exports, $\tilde{\xi}$, can be negative even though exports are privately profitable (i.e. $\tilde{\pi} > 0$). This occurs if $F > \tilde{\pi} + (\overline{W}_X - W_D)\ \tilde{L}_X$. We therefore arrive at the condition:

$$F < \tilde{\pi} + (\overline{W}_X - W_D)\ \tilde{L}_X \Rightarrow (T = X, L = {\sim}M) \succ_{GNP} (T = {\sim}X) \qquad (6)$$

Conditions (4) and (6) together give us a GNP ranking for Model 4:

$$\pi^* > F > \tilde{\pi} + (\overline{W}_X - W_D)\ \tilde{L}_X \Rightarrow (T = X, L = M) \succ_{GNP} T = {\sim}X \succ_{GNP} (T = X, L = {\sim}M) \qquad (7)$$

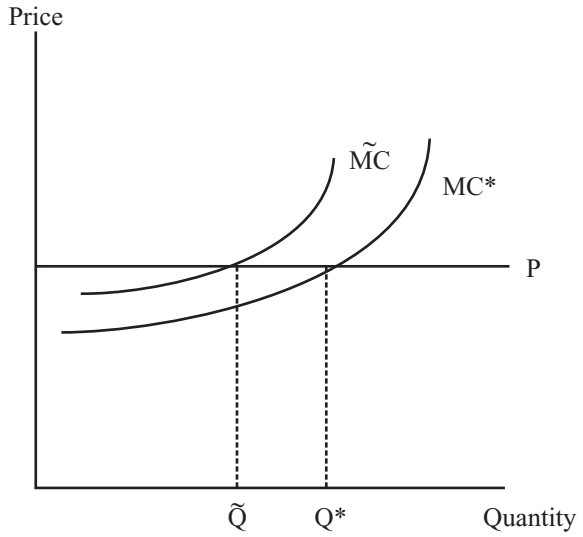
which states that the fixed cost of exporting must be small enough that it can be outweighed by private profitability in the market wage case, yet large enough to overcome private profitability and wage gain in the non–market wage case. Any set of parameters satisfying these requirements would have the property that an export orientation would raise GNP if wages are market–determined but not if they are set above market–clearing levels.

The interpretation of condition (7) is aided by subtracting F from each term on the left–hand side and writing the result as:

$$\xi^*(Q^*_X) > 0 > \tilde{\xi}\ (\tilde{Q}_X) \qquad (7')$$

with Q^*_X and $\tilde{Q}_X$ denoting the profit–maximising levels of export production under market wage determination and non–market wage determination respectively and ξ^* and $\tilde{\xi}$ the corresponding levels of social profit. Q^*_X is greater than $\tilde{Q}_X$, because the marginal cost curve of the export firm has shifted up when wages are above market–clearing levels, implying that some output units that would have been profitable under $W_X = W_D$ are not profitable under $\overline{W}_X > W_D$. Figure 4 illustrates this. Revenue ($P_X Q_X$) moves accordingly. Condition (7') then says that the export revenue generated by the relatively high export volume under market wage determination is sufficient to cover the costs of promoting the export industry, but the revenue generated by the relatively low export volume under non–market wage determination is not.

Figure 4. **Export Volume under Market and Non-market Wage Determination**



~ = Market wage determination
* = Non-market wage determination

Model 5: This model differs from Model 4 in that it replaces the efficient on–the–job search assumption by the Harris–Todaro (1970) assumption that to get a job in the export sector, one must migrate there. Equations (1)–(4) hold as before; the others must be replaced. In this model, the equilibrium allocation of the labour force between sectors is given by the Harris–Todaro equilibrium condition

$$\overline{W}_X L_X / (L_X + L_U) = W_D \tag{8}$$

wherein the expected wage in the export sector (the wage if employed multiplied by the ratio of jobs to job seekers) equals the expected wage in the domestic goods sector. Substituting (8) into (3), we obtain the social profitability of exporting in Model 5:

$$\tilde{\xi} = \tilde{\pi} - F \tag{9}$$

[No terms involving wage gains appear in (9), because the increase in wage bill among those employed is exactly offset by the loss in wage bill due to induced unemployment.] Hence, the condition for exports to be socially unprofitable under non–market wage determination becomes

$$F < \tilde{\pi} \Rightarrow (T = X, L = \sim M) \succ_{GNP} (T = \sim X) \qquad (10)$$

in Model 5 and the rank reversal condition becomes

$$\pi^* > F > \tilde{\pi} \Rightarrow (T = X, L = M) \succ_{GNP} T = \sim X \succ_{GNP} (T = X, L = \sim M) \qquad (11)$$

In summary, the models in this section have observed the possibility that:

i) A policy of export promotion (i.e. spending public funds to subsidise the private sector) produces higher GNP than an inward–looking trade strategy when wages in the export sector are market–determined.

However:

ii) The ranking reverses when wages in the export sector are set institutionally above market levels: the inward–looking trade strategy produces higher GNP than an export–oriented trade strategy under wages not market–determined.

Therefore:

iii) Whether an export–oriented trade strategy raises GNP or lowers it depends in part on the labour market regime within which trade policy is chosen.

This analysis demonstrates that the labour market regime might cause a reversal of trade policy, but not that it necessarily will do so.

Not to be able to export profitably is bad. To export unprofitably is worse.

Policy Conclusions

The first part of this paper reviewed the employment–generation and poverty–reduction records of newly emerging economies in various parts of the world. It observed a pronounced contrast between the remarkably rapid reductions in poverty and improvements in labour market conditions that have taken place in East Asia and the distressing lack of progress in Latin America. Of course, the East Asian countries achieved high economic growth while Latin America has had much more limited, and in some cases even negative growth. High growth causes improvements in labour market conditions and reductions in poverty, and for this reason it should be sought. Those who avoid it because they believe that it increases the misery of the poor are simply wrong.

The second section of the paper then compared the labour market institutions in East Asia with those in other developing regions. While most countries in Latin America and elsewhere have tried to reduce poverty and improve labour market conditions by directly pushing labour market conditions up, East Asia followed a much more indirect approach, relying on growth to pull conditions up. The models showed how wages above market–clearing levels might reduce both employment and output and, contrariwise, how, with market wage determination, all of a country's workers might share in the rapid growth that takes place. These data and analytical models suggest that the indirect approach to raising labour standards was the more fruitful one in East Asia and might be so in other parts of the developing world as well.

The models developed in the third section demonstrated that an export promotion activity that may be socially desirable with market–clearing wages may be socially undesirable when wages are set above market–clearing levels. In particular, the gains from adopting an export–oriented trade strategy depend in part on the labour market regime within which trade policy is chosen. These results have implications for policy:

a) If the country's labour market regime is immutable — say, because of a politically based decision to encourage strong trade unions or because of the belief that minimum wages are good in and of themselves — export promotion may cease to be socially profitable. Wages in some countries' export sectors are two or three times market–clearing levels. Such countries start out at an enormous disadvantage in trying to compete successfully in world markets with the OECD countries and the newly industrialising economies. If primacy is accorded to labour market policy, promoting exports may not be warranted.

b) If the country's labour market regime is a genuine policy instrument, labour market policy should be made in conjunction with trade policy. The two policies interact; the optimal trade policy depends on the choice of labour market policy and *vice versa*.

These models raise an important note of caution for policy makers. The advice now so freely dispensed — "develop via exports" — may well suit a country with market–determined wages but become quite disastrous otherwise because higher than market–clearing wages may adversely affect the ability to export and the social gains from exporting. This does not endorse wage repression; it argues for allowing wages to be pulled up by increasing competition for workers through export–led growth rather than pushing them up prematurely by non–market means.

Some very difficult transition issues may arise. Consider a country that starts with a dualistic wage structure and then seeks to reform its labour market policies in an attempt to stimulate economic growth. Although employment opportunities should improve and poverty decline throughout the economy once a new equilibrium is achieved, these benefits take effect only in the long run. Meanwhile, in the short run, individuals working in the favoured segments of the labour market, who stand to lose wages, benefits, or job security if reform is undertaken, may constitute a potent political force in opposition to the reform programme.

One policy response would be to try to buy the support of the potential losers. This presents two immediate problems. It may be quite expensive because of the large magnitude of the potential losses or, because the losers were relatively advantaged in the economy to begin with, it is not at all obvious that they most deserve support. Some countries demonstrate an unfortunate tendency to think of "the poor", "the vulnerable", and "the losers" as the same people and to design programmes for those who scream the loudest, namely the losers. Governments themselves must decide which group presents the most compelling case and therefore most deserves the limited safety net resources available.

Notes

1. The average annual growth rates in real terms between 1976 and 1992 were 8.4 per cent in Chinese Taipei, 7.9 per cent in Korea, 7.2 per cent in Hong Kong, and 7.1 per cent in Singapore. Asian Development Bank (1993).

2. To put matters in some perspective, let it be noted that in my own country (the United States) over the last 25 years, median real earnings rose by just half a per cent a year in the 1970s and then fell by half a per cent per year in the 1980s and 1990s (Juhn and Murphy, 1995, Table 1). The US unemployment rate has been inching its way down and is now close to 5 per cent.

3. The phrase is due to Haggard (1994). See also Deyo (1989), World Bank (1993), and You (1994).

4. For example, Fishlow *et al*. (1994), Krugman (1994), Rodrik (1995), and Young (1995).

5. For reviews of Singapore's wage repression policy in the 1970s and subsequent wage correction policy, see Fields and Wan (1989) and Lim (1990).

6. The crowding model was first developed by Bergmann (1971) to explain why the exclusion of blacks from certain occupations led to higher wages of whites in those occupations. A consequence of such discriminatory behaviour is that blacks earn less in the occupations into which they are crowded, hence the name "crowding model".

7. This seemingly innocuous condition is sometimes forgotten when exporting is advocated regardless of profitability.

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Stabilisation with Growth: Implications for Emerging Economies

Kiichiro Fukasaku and Lisbeth Hellvin[1]

Introduction

About a dozen developing countries and countries in transition (collectively often called "emerging market economies" or "newly emerging economies"[2]) have experienced surges in private capital inflows during the past five years. These surges result from a combination of several factors, such as low real interest rates and slow growth in industrial countries, better growth prospects in developing countries after outward–oriented policy reforms, and the increased openness of domestic financial markets to foreign investors. The last reflects the desire of developing countries to tap investment funds more effectively and efficiently from international capital markets. Freer capital movements are *not* devoid of risks, however. The currency crises in Turkey in early 1994 and in Mexico in late 1994 provide us with a stark reminder that large capital inflows and sudden outflows can create substantial problems for macroeconomic management in emerging economies. Other emerging economies also face the difficulties of integrating themselves into global financial markets.

A key policy challenge for emerging economies thus hinges on how to secure price stability and long–run growth by pursuing open economy reforms while managing the macroeconomic risks posed by liberalised capital movements. Inflation does not now pose a major issue of concern for most emerging Asian economies, and it appears to have become subdued in Latin America as well. Yet emerging economies will continue to attract or need to attract foreign capital, making domestic stabilisation an important policy issue. Each emerging economy has adopted a different policy mix to limit macroeconomic disturbances arising from large and reversible capital inflows.

This paper reviews salient features of recent episodes of large capital inflows and policy responses taken by several emerging economies in Asia and Latin America and discusses appropriate safeguards from a longer–term perspective. One needs to distinguish between the long–term gains derived from financial liberalisation and the risks involved in such policy reform. The episodes of macroeconomic instability

experienced by emerging economies in the face of large capital inflows and sudden outflows in the past few years suggest that exchange rate policy should be managed more flexibly on the one hand, and fiscal policy tightened on the other. In this way, monetary policy can more effectively secure price stability and thus longer–run growth. Yet the question of how to enhance the credibility of monetary policy remains unsettled.

The next section briefly reviews developments in private capital flows to developing countries and discusses the main policy responses — sterilised intervention, fiscal consolidation, restrictions on capital flows and greater flexibility in exchange rates — in managing macroeconomic risks posed by liberalised capital movements. The third section turns to a longer–term issue: how emerging economies can safeguard macroeconomic stability while maintaining sustained growth. It reviews a growing body of literature on inflation and long–run growth and discusses its policy implications, also drawing some lessons from the recent experience of OECD countries with respect to inflation targeting as a nominal anchor for monetary policy.

Private Capital Flows and Macroeconomic Risks

In 1995, aggregate net flows of private, long–term capital to developing countries increased moderately from their 1994 level, despite the Mexico crisis in late 1994 and its aftermath. The currency and stock markets in most emerging market economies proved rather resilient to adverse repercussions from Mexico once the initial shocks were absorbed, and then showed a strong recovery in the second quarter of 1995. Developments in emerging markets since the early 1990s provide some important lessons about how emerging economies manage the macroeconomic risks associated with large capital inflows and their possible reversal.

Private Capital Flows in the 1990s

The first five years of the 1990s witnessed a strong surge in private capital flows to developing countries (Table 1). Aggregate net inflows of private long–term capital more than tripled between 1990 and 1993, although their growth slowed considerably in 1994 and 1995. Aggregate inflows reached an estimated US$167 billion in 1995, compared with US$44 billion in 1990. East Asia has seen a particularly strong increase. In 1995, aggregate inflows to East Asia estimated at US$98 billion amounted to about 6 per cent of the region's aggregate GNP. East Asia alone accounted for nearly half of private capital flows to all developing countries in 1990–95. South Asia also has received more private capital, although from a much smaller base. In Latin America, private foreign capital, which had virtually dried up in the 1980s, began to flow strongly in the early 1990s as economic conditions in the region improved considerably; but the flow checked in 1994 and 1995, due largely to the rise in US real interest rates in 1994 and the Mexico crisis in December 1994 and its aftermath. Private flows to other developing regions have also shown strength, particularly to Europe and Central Asia in the early 1990s, when foreign investors responded positively to privatisation programmes.

Table 1. **Net private capital flows to developing countries[a], 1990-95**
(US$ billion)

Country group or country	1990	1991	1992	1993	1994	1995[b]
All developing countries	44.0	61.6	100.3	154.2	158.8	167.1
	(1.0)	(1.4)	(2.2)	(3.2)	(3.1)	(3.0)
Sub-Saharan Africa	0.2	1.0	0.3	-0.8	4.7	5.0
	(0.1)	(0.4)	(0.1)	-(0.3)	(1.7)	(1.7)
East Asia and the Pacific	20.4	26.2	44.7	62.9	77.3	98.1
	(2.3)	(2.6)	(4.0)	(5.3)	(5.7)	(6.0)
South Asia	2.4	2.1	2.8	4.6	7.4	6.0
	(0.6)	(0.6)	(0.8)	(1.3)	(1.9)	(1.4)
Europe and Central Asia	8.2	7.1	21.6	25.0	15.6	17.3
	(0.6)	(0.5)	(1.7)	(2.0)	(1.4)	(1.6)
Latin America and the Caribbean	12.2	22.7	30.4	58.8	49.7	33.9
	(1.2)	(2.1)	(2.6)	(4.4)	(3.3)	(2.2)
Middle East and North Africa	0.5	2.4	0.4	3.8	4.1	6.8
	(0.1)	(0.5)	(0.1)	(0.8)	(0.8)	(1.3)
By country of destination[c]						
China	8.1	7.5	21.3	38.0	46.6	44.7
	(2.3)	(2.0)	(5.1)	(8.8)	(8.9)	
Mexico	8.2	11.9	9.2	21.9	17.4	10.9
	(3.4)	(4.2)	(2.8)	(6.1)	(4.8)	
Brazil	0.5	3.2	9.7	16.1	11.9	6.9
	(0.1)	(0.9)	(2.6)	(3.8)	(2.2)	
Korea, Republic of	1.1	5.5	7.5	8.7	8.1	16.5
	(0.4)	(1.9)	(2.5)	(2.6)	(2.3)	
Malaysia	1.6	3.8	6.4	8.7	6.7	12.1
	(3.9)	(8.5)	(11.7)	(14.5)	(10.0)	
Argentina	-0.2	2.9	5.8	13.7	8.2	8.8
	(-0.1)	(1.6)	(2.6)	(5.4)	(2.9)	
Indonesia	3.3	3.5	4.7	0.5	7.4	11.4
	(3.0)	(2.9)	(3.5)	(0.3)	(4.4)	
Thailand	4.7	5.0	4.0	4.4	4.1	8.2
	(5.6)	(5.1)	(3.7)	(3.6)	(2.9)	
Russia	4.3	0.2	10.5	3.1	0.7	3.6
	(0.7)	(0.0)	(2.2)	(0.7)	(0.2)	
India	2.1	1.9	2.0	3.5	5.5	4.4
	(0.7)	(0.7)	(0.7)	(1.4)	(1.9)	
Turkey	1.7	1.1	4.5	7.2	1.5	2.3
	(1.1)	(0.7)	(2.9)	(4.0)	(1.2)	
Hungary	-0.3	1.0	1.2	4.7	2.7	5.0
	-(0.9)	(3.1)	(3.4)	(12.6)	(6.8)	
Percentage share of top 12 countries	79.8	77.2	86.6	84.6	76.1	76.0

Note: Figures in brackets are expressed as a percentage of GNP.
a) Long-term only.
b) Preliminary.
c) Country rankings are based on cumulative 1990-95 private capital flows received.
Source: World Bank (1996).

How do these flows compare with those in earlier periods? In 1990–95, the estimated annual average of net private inflows to all developing countries, at US$114 billion, equalled 2.4 per cent of their aggregate GNP; corresponding figures were 1.2 per cent for the 1982–89 debt crisis period and 2.7 per cent for the previous era of large inflows, 1978–81. These numbers mask a key divergent trend. In East Asia, the annual average of net private inflows measured as a percentage of GNP rose steadily from 1.8 per cent in 1978–81 to 1.5 per cent in 1982–89 and to 4.6 per cent in 1990–95, while in Latin America the figures fell from 2.7 per cent to 1.2 per cent and then rose again, relatively modestly, to 2.4 per cent[3]. Thus, in historical perspective, the emergence of East Asian countries, notably China, Indonesia, Korea, Malaysia and Thailand, as the main recipients of private capital flows characterised the 1990s.

Another salient feature: while capital flows in the 1970s largely took the form of syndicated bank loans to the public sector, the primary vehicles in the 1990s have involved equity investment, both direct and portfolio. In 1990–95, equity flows accounted for nearly 70 per cent of private capital flows to all developing countries, compared with merely 18 per cent in 1978–81[4]. Foreign direct investment (FDI) has risen steadily, due largely to an economic boom in East Asia, particularly in China[5], but portfolio equity flows, which grew more than tenfold between 1990 and 1993, dropped sharply in 1994 and 1995.

The 1990–95 movements in portfolio equity flows reflect how greatly cyclical factors and sudden changes in investors' sentiment influence equity investment. Fernández–Arias and Montiel (1996) argue that falling US interest rates in the early 1990s operated as an important "push" factor in driving private capital to developing countries; the long–term US government bond yield fell from 8.55 per cent in 1990 to 5.82 per cent in 1993 before rising to 7.11 per cent in 1994. Other "external" factors negatively affecting capital flows included the Mexico crisis in late 1994 and the exceptionally strong US stock market performance in 1995 (World Bank, 1996, p. 4).

Some emerging economies, such as Argentina, Brazil, India and the Philippines, suffered more persistent contagion effects from the Mexico crisis than others. Stock markets in Chile, Indonesia, Malaysia and Thailand as well as Asian NIEs had rebounded strongly and more or less restored their pre–crisis levels by April 1995 (BIS, 1995). Thus, the aftershocks from Mexico proved rather transient as initial financial market fear of a systemic crisis faded away — although foreign investors still show more discriminatory attitudes to emerging markets than before.

Macroeconomic Risks and Stabilisation

The benefits of full access to international capital markets are well recognised (OECD, 1995, pp. 33–38). International capital markets serve several functions:

— Improving the allocation of savings and investment by channelling scarce resources to the best uses;

— Providing liquidity and reducing the constraints of self–finance, thereby smoothing consumption and investment over time;

— Reducing risk through portfolio diversification;

— Increasing competition among banks and other financial institutions; and

— Disciplining governments to adopt sound policies[6].

Thus, the increase in private capital inflows in the 1990s is a "good thing" for emerging economies. Because freer capital movements potentially increase welfare, both developed and developing countries have deregulated international capital movements as an integral part of domestic financial reform. Current episodes of large capital inflows, however, demonstrate that increased financial integration has made emerging economies more dependent on international macroeconomic developments such as international interest rate shocks. The slowdown in the growth of private capital flows in 1994 and 1995 has made policy makers in emerging economies very sensitive to the sustainability of capital inflows.

Difficulties in managing capital inflows may arise when emerging economies run at or near full capacity. Then, heavy inflows may become disruptive as they lead to large appreciations of real exchange rates under fixed or quasi–fixed exchange rate regimes, heighten inflationary pressures through increased money supply and widen current account deficits to an unsustainable level[7]. If capital flows are highly volatile, they would also increase uncertainty. Sudden large outflows, as in the cases of Turkey and Mexico, would create a liquidity problem in the domestic banking system and cause a loss of credibility in government policy, leading to a run on the currency.

Emerging economies faced with large capital inflows have broadly four policy options which they have used in various combinations: sterilised intervention; fiscal restraint; controls on capital movements; and greater exchange rate flexibility[8]. The policy measures actually taken by several emerging economies in Asia and Latin America during 1990–94 have been reviewed in detail by the IMF (1995) and others (Corbo and Hernandez, 1994; Goldstein, 1995; Glick and Moreno, 1994; Fernández–Arias and Montiel, 1996; and Kuroyanagi and Hayakawa, 1996).

The case for sterilised intervention is well documented, particularly in the East Asian context (Reisen, 1993). It aims to reduce pressures on nominal exchange rate appreciation, while at the same time limiting the expansion of the monetary base associated with the central bank's accumulation of foreign reserves as a result of foreign exchange market intervention. Sterilisation is usually conducted through open market operations in government bonds or central bank certificates, changes in reserve requirements or the management of public sector deposits. Since the late 1980s, most emerging economies with heavy capital inflows in Asia and Latin America (a notable exception is Argentina) have adopted sterilised intervention policies.

Malaysia provides a typical case in point. Net flows of private capital to Malaysia jumped from US$1.6 billion in 1990 to US$8.7 billion in 1993[9], corresponding to 3.9 per cent and 14.5 per cent of GNP, respectively. In early 1992 the central bank,

Bank Negara, began sterilised intervention through open market operations by selling treasury bills and later its own paper, as well as by borrowing heavily in the interbank money market. In addition, Bank Negara increased the reserve requirement for commercial banks in several steps, from 3.5 per cent in mid–1989 to 11.5 per cent in 1994, to lower the money multiplier and thereby reduce the monetary expansion that results from intervention in the foreign exchange market. Government and Employee Provident Fund (EPF) deposits, which had been placed with the banking system, were transferred to Bank Negara. At the same time, the government adopted restraint measures to reduce its fiscal deficit significantly; the central government's fiscal balance swung from a deficit of 2 to 3 per cent of GDP in 1990–92 to a surplus of 0.2 per cent in 1993 and 2.4 per cent in 1994. In the face of a surge in net short–term portfolio inflows, the government has also allowed greater flexibility in exchange rates since mid–1991. Despite all these efforts, however, the Malaysian authorities decided in January 1994 to impose more direct — but temporary — restrictions on non–trade foreign exchange transactions by commercial banks in its attempt to curb short–term capital inflows and counteract speculative attacks in 1993–94[10].

Recent episodes of heavy capital inflows in Malaysia and other emerging economies where sterilisation had to be moderated or terminated, such as Chile, Colombia and Indonesia, suggest a number of lessons with respect to policy responses by host countries. First, sterilisation through open market operations may cause the central bank to bear quasi–fiscal costs, which result from the difference between the higher interest rates paid on these securities and yields on foreign exchange acquired by the central bank. Such operations may also widen domestic and international interest rate differentials, thereby attracting more short–term capital inflows.

Increases in the reserve requirement provide another instrument to neutralise the expansionary impact of capital inflows on the domestic monetary base. This is equivalent, however, to increasing a tax on banks and, as in the case of Indonesia, not practical to use when the domestic banking system remains underdeveloped[11]. Moreover, an increase in the reserve requirement may lead to higher lending rates, thereby inducing domestic firms to borrow more abroad and generate higher capital inflows.

Second, tightening fiscal policy is an effective instrument as it helps to reduce aggregate demand, lower interest rates and thus discourage capital inflows. Chile, Malaysia and Thailand used it extensively in 1990–94 (IMF, 1995)[12]. More recently, in a response to capital *outflows* in the aftermath of the Mexico crisis in late 1994, the Philippines government tightened fiscal expenditure promptly to counterbalance a heavy loss of foreign reserves during the first and third quarters of 1995. This demonstrates that fiscal policy can be used effectively, as at least part of a policy package, in dealing with the sudden reversal of capital flows (Kuroyanagi and Hayakawa, 1996).

Third, Malaysia's recent experience appears to suggest that a switch from sterilised intervention to capital control measures works, in the short run, to reduce the volume of capital inflows by lowering domestic interest rates kept high during the sterilisation

period. Capital controls imposed over a prolonged period, however, develop reduced effectiveness and their side effects become so large as to be detrimental to the development of domestic financial markets.

Finally, many emerging economies faced with large and volatile capital flows have accepted greater exchange rate flexibility. This may become necessary for fast–growing emerging economies as the cost of sterilisation increases over time. Greater flexibility takes the form of wider exchange rate bands around either a fixed or crawling peg (Chile and Colombia) or wider intervention bands under a managed float (Indonesia and Malaysia). As Goldstein (1995) points out correctly, if a host country no longer needs to generate a large current account surplus to meet debt payments, a higher real exchange rate would be consistent with economic fundamentals, particularly when the host country's tradeable sectors are enjoying higher productivity growth than non–tradeable sectors.

How should emerging economies conduct exchange rate policy under liberalised capital movements? The exchange rate regimes of emerging economies in Asia and Latin America vary widely: free float (India, Mexico, Philippines), managed float (Brazil, China, Indonesia, Korea, Malaysia, Singapore), crawling bands (Chile and Colombia), peg to a currency basket (Thailand) and peg to the US dollar (Argentina, Hong Kong and Venezuela). Despite these wide differences in formal regimes, however, many of these economies have maintained a *de facto* peg to the US dollar[13]. Nevertheless, recent episodes in Mexico and other emerging economies deliver the important message that a fixed exchange rate is unstable in the face of large capital inflows and sudden outflows. Greater exchange rate flexibility is the key ingredient for an emerging economy's policy mix. The choice of an exchange rate regime also has extreme importance for domestic stabilisation policy and has to be decided from a much broader consideration of price stability and longer–run growth rather than capital flows alone. How should emerging economies secure a stable macroeconomic framework conducive to growth? How should they enhance or maintain the credibility of monetary policy when exchange rates need greater flexibility?

Openness, Price Stability and Long–run Growth

A stable macroeconomic framework is a necessary but not sufficient condition to sustain long–run growth (S. Fischer, 1993). Low and predictable inflation, a *sine qua non* for a stable macroeconomic framework, has formed a cornerstone of East Asia's "miracle" stories (World Bank, 1993). Inconsistent with an outward–oriented development policy, high inflation leads to real exchange rate appreciation under a fixed or quasi–fixed exchange rate regime and a corresponding loss of international competitiveness. It hurts investment and productivity growth by distorting price information required for an efficient allocation of resources and by raising uncertainty about future inflation and risk[14].

Empirical evidence, however, is not unambiguous concerning the relationship between inflation and growth. While some studies support the hypothesis that lower inflation is associated with higher rates of economic growth, others do not find any significant correlation[15]. Considering the different approaches used by existing empirical studies (the sample of countries, time period, etc.), the mixed results are not surprising[16].

The ambiguity of empirical evidence arises partly from the non–linear effects of inflation on economic growth. Bruno and Easterly (1995) argue that inflation would have a negative impact on growth only in countries with high–inflation crises (defined as annual inflation of over 40 per cent). Long–run averages of growth correlate only weakly with inflation and a consistent relationship does not appear when countries with high–inflation crises are excluded. Sarel (1996) further examines the hypothesis of non–linear effects of inflation on economic growth, based on a sample of 86 developing and developed countries for 1970–90. He finds low inflation to have no significant or even positive effect on economic growth, but uncovers a structural break at an annual inflation rate of 8 per cent, above which inflation has a significant and robust negative effect on growth. He suggests that this may explain why some previous studies failed to find any such relationship. Empirical results do seem very sensitive to the samples of countries, the sample periods, and the specifications of variables and methods[17]. This does not disturb a general consensus that high inflation harms economic growth, leaving unsettled only the level of inflation at which the harm becomes significant[18].

Inflation and Growth in Different Regions

Table 2 shows the large regional differences in inflation rates, which generally are significantly lower in industrial than in developing countries. The average rate of inflation among the latter in the 1980s reached almost 62 per cent, with the corresponding figure for industrial countries at only 4.5 per cent. Some Latin American countries have suffered from extremely high inflation. The shock–inflation countries include those with large external debts and generally very poor growth performance. Argentina, Brazil, Bolivia, Nicaragua and Peru have had episodes of three–digit or even four–digit levels of inflation, e.g. over 2 600 per cent in Brazil in 1994 and over 3 000 per cent in Argentina in 1989. Shock inflation has damaged economic performance. In a study of 12 Latin American countries in the period 1950–85, De Gregorio (1992, 1993) found high inflation to be the main factor hindering economic growth. Average annual inflation in the region reached almost 250 per cent in the 1980s; the average annual growth rate held at only about 1 per cent. In the 1990s, however, inflation has dropped significantly in many Latin American countries. The OECD forecasted a dramatic fall of inflation in Brazil to 12 per cent in 1997 and in Venezuela to 40 per cent (OECD 1996*b*, Table 26, p. 140).

Table 2. **Average Annual Inflation and Economic Growth in Different Regions**
(Per cent per year)

	1965-73	1973-80	1980-90
Asia			
Inflation	14.8	8.9	6.9
Growth	5.8	5.8	6.9
Africa			
Inflation	5.2	15.8	18.9
Growth	3.7	3.4	2.1
Latin America			
Inflation	22.0	53.0	249.0
Growth	6.0	5.0	1.1

Source: S. Fischer (1993), Table 1.

By contrast, Asia distinguishes itself from other developing regions by its relatively low inflation. Most emerging Asian economies have successfully controlled it, recording rates close to those in industrial countries. Asia had an average rate of inflation in the 1980s of about 7 per cent, lower than in any other region. Singapore has had the lowest rate of inflation in the 1990s, at 2–3 per cent, followed by Malaysia with 3–4 per cent and Chinese Taipei with 3–5 per cent. On the other hand, China, India and Indonesia have occasionally reached two–digit inflation in the 1990s. The OECD forecast for 1996 and 1997 indicates that, except for China, Asian emerging economies will maintain single–digit inflation rates (OECD, 1996*b*, Table 25, p. 137).

Openness and Inflation

Why do most Asian emerging economies succeed in maintaining low inflation? Empirical evidence shows a strong relationship between degree of openness and the rate of inflation (Romer, 1993). It is statistically significant and quantitatively large for all countries except high–income countries in which the rate of inflation is generally low and independent of the degree of openness. Small and more open economies tend to have lower average rates of inflation. The short–run benefit of unanticipated monetary expansion tends to decrease with the degree of openness[19].

Asian emerging economies present good examples of economies both very open and very successful in maintaining price stability, with less incentive and pressure to inflate than in other regions (Moreno, 1994). The larger incentive to maintain price stability derives from the region's greater dependence on foreign trade. Higher economic growth and a better fiscal position also help reduce political pressures to inflate.

The emerging economies in Latin America are much less open than their counterparts in Asia (Table 3). Argentina and Brazil remain relatively closed, with exports and imports accounting for only about 12–13 per cent of GDP. Chile and Venezuela, more dependent on trade, have trade–GDP ratios at 43 and 39 per cent, respectively, still lower than in most Asian emerging economies.

Table 3. **Trade Openness, 1994**

Country	Openness
Singapore	289.3
Hong Kong	237.5
Malaysia	158.3
Chinese Taipei	73.9
Thailand	68.0
Philippines	54.5
Republic of Korea	50.6
Indonesia	45.9
Chile	43.0
Venezuela	39.0
China	38.1
Colombia	29.1
Mexico	24.9
India	19.6
Argentina	13.2
Brazil	12.0

Note: Openness is defined as merchandise exports plus imports as a percentage of GDP.
Source: World Bank CD-Rom 1995, and Taiwan *Statistical Data Book*.

Central Bank Independence

In addition to the negative relationship between openness and inflation, Romer (1993) shows that inflation tends to be higher in countries with less independent central banks and in countries less stable politically. Several empirical studies have confirmed the importance of central bank independence in maintaining low inflation (see, e.g. Alesina and Summers, 1993; Grilli *et al.*, 1991; Barro, 1995). The case for an independent central bank to control inflation is two–fold (Cukierman *et al*., 1992, pp. 369–70). First, the central bank is more concerned about price stability than the political authorities. Whereas monetary policy has no long–run effects on real variables, politicians face the temptation to use monetary policy to reduce unemployment in the short run. That temptation, which would result in an inflation bias, erodes with increasing central bank independence. Second, legal independence reflects the extent to which the central bank has the public mandate to give priority to price stability over other objectives.

The degree of central bank independence differs widely across countries. Cukierman *et al*. (1992) constructed an index of central bank legal independence based on: the term of office of the chief executive officer of the bank; the authority of the central bank to set monetary policy even when it conflicts with the executive branch; whether price stability is the major or only objective; and whether its lending to the public sector is restricted. According to this index, industrial countries such as Germany, Switzerland, Austria, Denmark and the United States, and emerging economies such as Greece, Egypt, Costa Rica, Chile and Turkey, have highly independent central banks. On the other hand, Belgium, Norway, Japan, Spain and France as well as Poland, Morocco, Yugoslavia, Nepal and Qatar had less independent central banks in 1980–89.

Does central bank independence have any impact on inflation? The same authors found the central bank independence index negatively associated with inflation rates in industrial countries but *not* in developing countries. One plausible explanation for these results could involve the wide divergence between actual practice and law which is much larger for developing than for industrial countries. An alternative measure of central bank independence based on the rate of turnover of central bank governors (developing countries have, in general, higher turnover rates than industrial countries) shows a positive association with inflation in developing countries but not in industrial countries. The rate of turnover should matter for inflation if governments which frequently change their governors do in fact pick those supporting their own interests and biases.

For individual countries, the results are somewhat mixed. The predicted negative relation between central bank independence and inflation does not prevail everywhere. Emerging Asian economies, especially, show a much weaker relationship. Moreno (1994) argues that the success of price stability in Asia arises not necessarily from central bank independence but instead, and more plausibly, from the high degree of openness and thereby the low incentive to inflate.

Inflation Targeting as a Nominal Anchor?

Countries which have a large tradeable sector need indispensably a stable exchange rate for maintaining price stability and growth. Therefore, they tend to set their exchange rates in line with those of their main trading partners as an intermediate target for monetary policy. European countries with strong trade and investment links with Germany have used exchange rate targeting with the Deutschmark as a nominal anchor for monetary policy. Likewise, many emerging economies in Asia and Latin America which have the United States as the dominant economic partner have adopted, *de facto* or *de jure*, exchange rate targeting regimes with the US dollar as an anchor for domestic stabilisation policy. Such policies encounter three problems, however. First, they bring loss of monetary policy independence. This may not be bad when monetary

authorities lack policy credibility, but it ties their hands in achieving the ultimate goal — price stability. Second, the emerging Asian economies have intensified trade and investment linkages within the region over the past decade, which raises the question of what currency they should target. Although they have increasingly pegged to a basket of key currencies which normally includes the US dollar, the Deutschmark and the Japanese yen, the currency weights actually used do not necessarily reflect the relative importance of economic relationships[20]. Third, as discussed in the previous section, a pegged exchange rate is unstable in the face of heavy capital flows and sudden outflows. In addition, Glick *et al.* (1995) argue that a pegged exchange rate cannot serve effectively to control inflation in Asian economies. Intermediate targets, such as monetary aggregates and exchange rates, have also come into question as nominal anchors for price stability. In the 1990s, a number of countries have shifted to an alternative form of targeting — inflation targets[21].

Most countries now adopting inflation target regimes have a common background of credibility problems from monetary policies in the past. Several countries that previously used exchange rates as an intermediate target for monetary policy have turned to inflation targets[22]. The European currency crisis in September 1992 forced Italy and the United Kingdom to abandon exchange rate bands, and Finland and Sweden had to abandon their policies of shadowing the ERM. Inflation targeting has emerged as an alternative in their search for a new nominal anchor. New Zealand and Canada introduced inflation targets after long periods of high inflation. Spain (1994), Israel (1991), Mexico (1994) and Australia (1992) have also announced explicit inflation targets. Some countries have adopted two forms, both inflation and exchange rate targets, at the same time (Israel, Chile and Spain).

Inflation targeting has the advantage of a direct focus on price stability and thus greater monetary policy transparency, which makes policy costly in terms of reputation and lost credibility if the target is missed. The announcement of inflation targets has two important roles to play. First, it acts as a nominal anchor for monetary policy, financial markets and those involved in the price– and wage–setting processes. Second, it reduces inflation bias by making inflationary surprises to stimulate output and employment more costly. An inflation target is a precommitment not to use inflation to reduce unemployment in the short run at the cost of an inflation bias in the long run.

Inflation target regimes have a considerable variety of forms across countries. Differences involve institutional support; the commitment to and priority of the target; how explicit it is; whether it is decided by the central bank or the government, or both; the chosen index; the target level; the tolerance interval; and the nature of the escape clause. New Zealand, the first country to announce explicit inflation targets (in 1990), has most thoroughly adopted them. It announced an inflation target as part of far–reaching institutional reforms. Before these reforms, New Zealand had a long period of low growth, with inflation higher than in most OECD countries. The central

bank had little independence; the Minister of Finance could direct it to follow a particular policy without informing the public. Moreover, the objectives of monetary policy included not only price stability but also growth, full employment and balance–of–payments equilibrium. The reform made the achievement and maintenance of price stability the only objective. The Reserve Bank Act of 1989 specifies a unique set of alliances between the Reserve Bank and the government, with a greater division of labour between the Minister of Finance and the central bank. The government decides on the objective of monetary policy but the central bank freely chooses the means to achieve it, with the Governor accountable for the outcome and removable from his post if the target is missed (A.M. Fischer, 1993, 1995; Ammer and Freeman, 1995).

Several industrial countries — including Canada, the United Kingdom, Sweden and Finland — have followed New Zealand and announced official inflation targets. They have not, however, made any institutional reforms of the monetary policy framework like those in New Zealand. New Zealand remains the only country where the central bank independently chooses the means to fulfil the goal and is also accountable for its achievement. All other countries have less thoroughgoing inflation target regimes[23].

Israel and Spain have both exchange rate and inflation targets. They introduced explicit inflation targets mainly to support prevailing exchange rate regimes[24]. Israel announced inflation targets when it moved to a crawling peg. Their experiences highlight some problems with the announced inflation target in an environment with two monetary anchors. Leiderman and Bufman (1996, pp. 95–96) discuss potential conflicts between these two targets, arguing that monetary policy should be used principally to maintain price stability by targeting inflation goals and subordinating exchange rate targets.

Table 4 summarises inflation targets and actual performance for several countries[25]. The target ranges are normally 2–3 percentage points wide and set for a time horizon of about 2–3 years[26]. The absence of a specification of the tolerance of fluctuations around the target might cause a credibility problem because the target will never be met exactly (see e.g. Åkerholm and Brunila, 1995). Monetary policy affects inflation with a time lag so that the pre–announced target should be achieved over a sensible time frame in a forward–looking way. In other words, its aim is to keep underlying inflation to a specified range over the course of the business cycle, rather than to hit the target at every moment.

Table 4. **Announced Inflation Targets and Rates of Inflation in Selected Countries, 1988-97**
(Per cent per annum)

Country	Quantitative Target	Rates of Inflation								Forecast Inflation	
		1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Australia (1992)*	Average of 2-3%	7.3	7.5	7.3	3.2	1.0	1.8	1.9	4.7	3.6	2.4
Canada (1991)	1-3% between 1995 and 1998	4.0	5.0	4.8	5.6	1.5	1.8	0.2	2.0	1.6	1.9
Finland (1993)	2% from 1995	5.1	6.6	6.1	4.3	2.9	2.2	1.1	1.1	2.4	3.0
New Zealand (1990)	0-2%	6.4	5.7	6.1	2.6	1.0	1.3	1.8	3.6	1.5	1.7
Spain (1994)	below 3% by 1997	4.8	6.8	6.7	5.9	5.9	4.6	4.7	4.8	4.5	4.5
Sweden (1993)	2% +/- 1% from 1995	5.8	6.4	10.5	9.3	2.3	4.6	2.2	2.9	4.0	4.2
United Kingdom (1992)	lower half of 1-4% by spring 1997; 2.5% or less thereafter	4.9	7.8	9.5	5.9	3.7	1.6	2.5	3.4	2.3	3.6
Israel (1991)	8-11% for 1995	16.3	20.2	17.2	19.0	12.0	11.0	12.4	12.0	9.2	7.7
Memo items:											
Total OECD		8.6	6.3	6.8	6.1	4.8	4.2	4.3	4.1	3.4	3.2
Total OECD less Mexico and Turkey		7.5	5.2	5.9	5.1	3.6	3.0	2.5	1.8	1.8	2.0

*Based on the speech delivered by the Governor of the Reserve Bank of Australia (*BIS Review*, No. 57, May 1996).

Sources: Haldane (1995), p. 8; DRI, *World Markets Executive Overview*, 2nd Quarter 1996; and *OECD Economic Outlook 58* (December 1995).

Experiences with inflation targets have generally been positive so far. Inflation has come down to within the specified ranges in most countries, even if some countries faced greater inflationary pressures in 1995. In New Zealand, for example, economic performance has improved considerably, with very high growth rates compared to other OECD Members in 1993 and 1994 while inflation remained below 2 per cent. Inflation indeed fell from 6 per cent a year in 1990 to 1 per cent after the target regime was introduced. In 1995, however, inflationary pressures heightened somewhat and the target was missed (OECD, 1996*a*, pp. 11–15) — but the forecasts for 1996 and 1997 suggest that inflation will be within the target range. Canada introduced inflation targets after a period of high inflation and disappointment with monetary targeting (A.M. Fischer, 1993)[27]. The new regime successfully brought down inflation from 6 per cent in 1991 to 1.5 per cent in 1992 and further to 0.2 per cent in 1994. Central banks in the United Kingdom, Finland and Sweden also have successfully reached their targets[28]. In Israel, however, several shocks have increased inflationary pressures and the target range of 8–11 per cent was missed in 1994 and 1995[29]. The inflation target in Spain is too recent to evaluate. According to the current forecast, however, inflation will remain above the target range of below 3 per cent.

Although inflation targeting has had generally positive outcomes, it came at a time when most OECD countries had few inflationary pressures. Moreover, such targets constitute a relatively recent phenomenon, too recent to support any strong conclusions. Nevertheless, an inflation target regime may provide an interesting alternative for emerging economies in their search for a nominal anchor for monetary policy.

Liberalised capital movements make it very important to strike a balance between the necessity for greater exchange rate flexibility and the credibility of an independent monetary policy whose aim is to maintain a stable macroeconomic framework conducive to long–run growth. From this perspective, inflation targeting may offer a practical option.

Conclusions

This paper has reviewed recent episodes of heavy capital flows in several emerging economies in Asia and Latin America, suggesting that maintaining a fixed exchange rate through heavy sterilised intervention becomes costly for the economy as a whole. Tight fiscal policy and a temporary use of capital controls can effectively manage large and volatile capital inflows. In the longer run, however, a gradual convergence of domestic inflation rates with those of industrial countries is needed to safeguard macroeconomic stability from foreign interest rate shocks. The monetary authorities in emerging economies may find it attractive to enhance the credibility of monetary policy by committing themselves to explicit inflation targets while allowing exchange rates to fluctuate more flexibly.

This particularly applies to those emerging Asian economies in which inflation has been brought down to single–digit levels. Heavy capital inflows and strong growth prospects require that exchange rates be managed more flexibly, allowing them to appreciate in nominal terms. Maintaining stable prices is a prerequisite for the continuation of financial reforms. In such circumstances, inflation targeting may serve as an effective anchor for monetary policy.

Many Latin American countries have also successfully moderated high and hyper inflation in the 1990s. They need greater flexibility in exchange rates to cope with external shocks such as changes in international interest rates, heavy capital inflows and sudden outflows. With increased flexibility in exchange rates as exemplified by the adoption of crawling bands, moderate–inflation countries need to enhance the credibility of monetary policy. In this context, inflation targeting once again can offer an attractive policy option (Leiderman and Bufman, 1996).

This paper has argued that the relative success of many emerging Asian economies, compared with those in Latin America, in achieving low inflation and high growth came in no small part from a high degree of economic openness and thus low incentives to inflate. Openness serves as an effective constraint on government not to choose an inflationary policy.

Empirical evidence shows that high inflation indeed hurts economic growth — but the non–linear nature of its impact on growth, as well as methodological and data con straints involved in empirical studies, leave unsettled the issue of the level at which inflation will impinge negatively on growth. Although a recent finding by Sarel (1996) that the structural break comes at around 8 per cent appears more plausible than earlier findings (e.g. 40 per cent), this important topic demands further research.

The importance of credibility and accountability in setting monetary policy *irrespective* of the policy regime adopted needs heavy emphasis. One advantage of inflation targeting lies in the transparency of policy–making processes. In general, credibility cannot emerge without subjecting policies to greater public scrutiny. Monetary policy is no exception.

Notes

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2. The authors are not aware of any "official" definition of "emerging market economies" or "newly emerging economies". For example, *The Economist* regularly reports economic indicators for 25 emerging markets, which includes several high–income non–OECD economies (Hong Kong and Singapore) and OECD Member countries (Czech Republic, Greece, Hungary, Portugal and Turkey) as well as Israel, South Africa and Russia. This paper restricts itself to selected Asian and Latin American "emerging economies".

3. The figures for 1978–81 and for 1982–89 are taken from Fernández–Arias and Montiel (1996), Table 1.

4. The figure for 1978–81 is taken from Fernández–Arias and Montiel (1996), Table 3.

5. FDI inflows to China are overestimated due to "roundtripping". Wang and Shilling (1995, p. 24) note that more than one–fourth of annual FDI actually involves such flows, i.e. illicit capital outflows repatriated back to China.

6. Reisen (1996) raises some doubt over the disciplinary role of international capital markets. He notes: "... global capital markets suffer from three major distortions: the problem of asymmetric information causes herd behaviour among investors and in good times, congestion problems; the fact that some market participants are too big to fail causes excessive risk taking; and the global financial markets feature multiple equilibria, unrelated to 'fundamentals'. It is questionable, therefore, whether the financial markets will discipline governments into better policies ..." (p. 281).

7. In Malaysia and Thailand, current account deficits registered –8.9 and –7.5 per cent of GDP, respectively, in 1995.

8. A number of emerging economies (e.g. Chile, Colombia, Malaysia, Philippines and Thailand) have removed or lowered controls on capital *outflows* as part of policy responses to capital inflows. The idea is to reduce the magnitude of *net* capital

inflows by leaving "exit doors" open. Whether such an exit policy can make an effective contribution to reducing net inflows is not certain, for it makes the host country more attractive for investment as it lowers the country risk (Goldstein, 1995; IMF, 1995).

9. Portfolio investment alone surged from US$80 million in 1990 to US$3.74 billion in 1993.

10. See Woo and Hirayama (1996) for an interesting account of speculative attacks and responses by monetary authorities in Indonesia, Malaysia and Singapore.

11. In Indonesia, the reserve requirement was reduced from 15 per cent to 2 per cent in 1988 to lower the cost borne by commercial banks and thus loan rates (Kuroyanagi and Hayakawa, 1996).

12. In Indonesia, this is not a policy option as a response to capital inflows because a balanced budget rules as a matter of principle.

13. For recent evidence on the relative importance of the US dollar in exchange rate policies of Asian developing economies, see Frankel and Wei (1994) and Bénassy–Quéré (1996).

14. The literature on the costs of inflation is reviewed by Briault (1995).

15. In cross–country studies, a significant negative correlation between inflation and growth is reported by Kormendi and Meguire (1985), De Gregorio (1992, 1993), S. Fischer (1993) and Barro (1995) In time–series analysis, Grimes (1991) found a significant negative relationship between output growth and inflation for 13 out of 21 industrial countries. The results suggest that an increase in inflation from zero to 9 per cent would reduce annual growth rates by one percentage point. In contrast, the results of Stanners (1993) for nine industrial countries show a weaker relationship between inflation and growth. In a pooled data study of determinants of real output growth including 113 countries over the period 1951–80, Grier and Tullock (1989) found the relationship to differ across regions. In OECD countries and in Asia, inflation variability was found to have a significant negative impact on growth.

16. In addition, inflation is an endogenous variable and the causality may also go in the opposite direction. In a situation with upward pressures on prices caused by high rates of growth we might even find a positive relationship between inflation and growth. The combination of a slowdown in economic growth and falling rates of inflation in China over the past two years is a case in point.

17. Levine and Renelt (1992) show that the results in many studies of growth become fragile with small changes in the data set. Krüger (1995) argues that the costs of inflation are not properly measured in studies mixing periods with different exchange rate regimes, since the impact of inflation on growth will differ between different exchange rate regimes.

18. See also Dornbusch and Fischer (1993) on the case of moderate inflation (15 to 30 per cent).

19. The estimated negative relationship between openness and inflation is quantitatively large; openness alone accounts for over 10 per cent of the cross–country variation in average inflation rates. The average rate of inflation in a closed economy is 18 per cent; 14 per cent in an economy with an import share of 25 per cent; 11 per cent for an economy with an import share of 50 per cent; and 8 per cent for an economy with an import share of 75 per cent.

20. Two recent studies, Frankel and Wei (1994) and Bénassy–Quéré (1996), suggest that the weight of the US dollar is predominant in estimated currency baskets for Asian economies.

21. Leiderman and Svensson (1995) and Haldane (1995) provide an overview of the issues and the recent experiences with inflation targets.

22. At the same time, there is a growing trend towards central bank independence.

23. See Bank of Japan (1995) for a useful review of inflation targeting in several OECD countries.

24. Israel has had a crawling peg regime since 1991 and Spain has been a member of the exchange rate mechanism of the EMS since 1989.

25. Most countries use the consumer price index when specifying the target. Some exclude factors beyond the control of the central bank, such as changes in indirect taxes in Canada and New Zealand and also government–administered prices, terms of trade and natural disasters in New Zealand. No country has announced a zero inflation target.

26. The argument for targeting a positive level of inflation is based on the presence of measurement biases. If the consumer price index is biased upwards, a zero inflation target would in fact imply deflation (see Brunila and Lahdenperä, 1995, p. 122, for a discussion of underlying factors causing measurement bias).

27. In 1975–82, M1 was used as the intermediate target. Thereafter, the central bank worked without any intermediate targets until 1991 when inflation targets were announced by the central bank and the government.

28. Svensson (1995) discusses some problems associated with the credibility of the Swedish target caused by a large public debt and budget deficit. This may rekindle inflation, as it would reduce the real value of nominal debt and the political division of monetary policy.

29. The reasons for this include optimism on the part of consumers and firms over the progress in the Middle East peace process; fiscal expansion and a rise in public–sector wages; monetary expansion and continuation and strengthening of asset–price inflation (Leiderman and Bufman, 1996, p. 100).

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Institutions and Economic Development

Chung H. Lee[1]

Introduction

For some years now, analysts have recognised institutions — the "humanly devised constraints that structure political, economic and social interaction" (North, 1991, p. 97) — as important in economic development (e.g. North, 1981 and 1990; Williamson, 1985). North (1991), in fact, considers that accounting for the evolution of political and economic institutions that create environments conducive to increasing productivity and economic growth offers the central challenge facing the study of economic development and economic history. By constraining the choices that individuals make, the manner in which they interact with others and the way that society allocates its scarce resources, institutions affect the path of economic growth[2].

Explaining how institutions have evolved over time in a given society will certainly, as North remarked, deepen our understanding of economic history and development. Many economists and policy makers concerned with contemporary developing countries and former socialist economies making the transition to a market system, however, face a more urgent challenge — to identify the institutions that promote or are at least conducive to economic growth. Finding "optimal" institutions for economic growth has immediate policy implications for economic development and transition.

Any society has groups of both informal and formal institutions (North, 1991). The former consist of sanctions, taboos, customs, traditions, codes of conduct and the like, while the latter include constitutions, laws, property rights and similar mechanisms. Whereas informal institutions are culture–specific and slow to change, people can establish formal institutions relatively quickly — although those not compatible with informal institutions may be ineffective and, worse, a source of conflict. This complementarity makes the design of optimal formal institutions a task not amenable

simply to some general theory or to sheer imitation. In fact, Lin and Nugent (1995, p. 2362) conclude in their review of the literature on institutions and economic development that:

> "... mere transplantations of successful institutions from DCs to LDCs is, at best, unlikely to have the expected positive effects on performance, and, at worst, may have rather disastrous effects. Where to start and how to bring out the reforms in a country are questions that can be answered only with serious consideration of the country's existing institutional structure and human and physical endowments."

This paper thus will not propose universally optimal institutions that, once established, will help the developing countries achieve rapid economic growth. Instead, it examines the experience of the host country of this conference, Korea, in order to find out which institutions may have contributed to its economic success and how they did so. Clearly, many of the institutions that have played a key role in Korea's economic development may not be directly transferable to other developing countries. What can be transferred, however, is the knowledge that certain institutions can play an important role in economic development and the recognition that the creation of such institutions can occur, as Lin and Nugent say, only in the context of a country's existing institutional structure and human and physical endowment.

Institutions Matter

Despite the recent contributions made by economic historians and the "new institutional economists", the importance of institutions for economic development has not been integrated into mainstream economics (Nabli and Nugent, 1989; Lin and Nugent, 1995). In fact, as North noted (1981), organisations or institutions, except for the market, do not exist in the standard neo–classical model[3]. Some reformers in Eastern and Central Europe view capitalism as nothing but a well–oiled system consisting only of private property ownership, pure *laissez–faire* and self–adjusting market mechanisms (Bruno, 1992). In a provocative article entitled "The Transition According to Cambridge, Mass." Murrell (1995) has criticised the standard reform package prescribed by western economists, or more specifically those associated with certain major educational institutions in Cambridge, Mass., for the transition economies in Eastern and Central Europe. This reform package, which consists of macroeconomic stabilisation, the liberalisation of domestic trade and prices, current account convertibility, privatisation, the creation of a social safety net, and the creation of the legal framework for a market economy, represents and typifies, as the title of his paper implies, the mainstream thinking on economic transition.

This one–size–fits–all prescription assumes that market systems are very much the same everywhere in the world and that history and institutions bear little relevance to their operation. Economic transformation, however, is a path–dependent process that depends on the initial conditions as well as policies and the external environment

(Ellman, 1994). Thus history and inherited institutions, slow to change, have a profound and enduring effect on the outcome of a reform package (Murrell, 1995). In fact, some observers of the reform process in Eastern and Central Europe are pessimistic enough about the speed of change in institutions to believe that successful reform may take a generation. According to Brzeski (1994, p. 6):

> "It will be years, in some cases decades, before the *Rechtsstaat* can create an environment favourable to private activities, especially those involving capital formation. Statutes can be altered easily enough; Western law teams stand by, keen to provide legal expertise. But it will take time for the complementary psychological, social, and cultural changes to take root. Perhaps only demography — a generational succession — can bring about those changes."

Several studies by the OECD and the East–West Center on the experiences of some transition economies in Central and Eastern Europe and Asia do in fact point out the institutional breakdown or the lack of market institutions as key factors determining differences in reform outcomes. Naughton (1994), for instance, identifies the absence of institutional breakdown as a critical factor accounting for the relative success of China's economic transition. He finds it notable that in China many institutions have continued to function, albeit poorly, whereas in Russia a number of key institutions broke down and completely ceased functioning. In a similar vein, Kirkpatrick (1994) points out that in carrying out their reform measures, the transition economies in Central and Eastern Europe failed to pay sufficient attention to the task of institution building in such areas as creating financial discipline, establishing effective bankruptcy procedures, reforming the banking sector and government administration, and initiating effective governance of state–owned enterprises.

The different experiences in transition teach an important lesson: that a functioning free market does not develop overnight once the central planning apparatus is eliminated and the market is freed. The transition to a market economy means more than eliminating the central planning system: it also requires establishing entirely new institutions, which in itself is a slow, time–consuming process (Aage, 1994; Rana and Paz, 1994; Winiecki, 1992)[4].

Adoption of the standard reform package in the transition economies of Eastern and Central Europe created a demand for institutional change since it had a direct impact on relative product and factor prices, constitutional order (the basic rules of government), technology, and the size of the market[5] — but, as demonstrated by their experience, the supply of new institutions has been slow to respond to the change in demand and to restore institutional equilibrium. Indeed, an "institutional hiatus" and a severe contraction in output and employment have resulted (Kozul–Wright and Rayment, 1995; Ellman, 1994)[6]. The supply depends, according to Feeny (1988), on the capability and willingness of the political order to provide new institutional arrangements[7]. These in turn hinge on existing institutional arrangements, the existing stock of knowledge, the motivation of elite decision makers, normative behavioural codes, etc. The Korean experience offers an important case study on how institutions may be created.

Initial Institutional Conditions for Industrial Development: The Case of Korea

According to a World Bank publication entitled *The East Asian Miracle* (1993), the East Asian economies have succeeded in achieving rapid economic growth by adopting the "fundamentals": macroeconomic stability, high investments in human capital, stable and secure financial systems, limited price distortions and openness to foreign technology — basically the same as prescribed for the transition economies in Eastern and Central Europe. The World Bank also points out, however, the presence of certain institutional arrangements in the East Asian economies as factors in their success: universal education, equitable land holding and land reform, support for small and medium–sized enterprises, the provision of low–cost housing, and the insulation of bureaucracy from narrow political pressures.

Korea established some of these institutional arrangements before the process of rapid economic growth began — a key fact often forgotten because much of the research on the Korean economy and its success tends to focus on economic reforms since the early 1960s and to ignore what had taken place during the preceding period. This has had the unfortunate effect of overemphasising the so–called fundamentals and disregarding the initial conditions prerequisite to their success[8].

In 1953, when the Korean War ended, Korean GDP and per capita income were, in 1975 prices, US$4 547 million and US$224, respectively. The economy consisted mostly of agriculture, fishery and forestry, which together accounted for 47 per cent of its GDP. Worse, most of the few light manufacturing industries that Korea inherited from the Japanese colonial period had been destroyed during the Korean War of 1950–53. Economic progress from 1953 to the early 1960s was by all indications lacklustre compared with what Korea has achieved since then. Yet the several institutional changes that took place during this period laid a foundation for rapid economic growth in subsequent years. They included land reform and redistribution, mass education and the growth of large private enterprises. The first two turned Korea into a relatively equitable society; the third increased human capital in entrepreneurship and management know–how; and the Korean army, by making farm hands members of a modern army, served as a training centre for a disciplined labour force capable of handling mechanised equipment and organising teamwork. By the early 1960s the Korean economy was ready for take–off, with a necessary catalyst provided by a political leadership equipped with a vision for economic development and appropriate economic policies.

Land Reform and the Demise of the Traditional Class Structure

Land reform in Korea began in 1945 when the US military government distributed over 240 000 hectares of formerly Japanese–owned farmland to their former tenant–cultivators. Under the Land Reform Act of 1949, the newly established government of the Republic of Korea extended the reform to include large Korean–owned farms. The Act also provided a powerful incentive to landlords and tenants to arrange voluntary

transfers of land. These official and voluntary measures brought about by 1959 a relatively equal distribution of land with an average farm size of less than 2.2 acres (Ban *et al*., 1980)[9]. Because a piece of land was the most important and perhaps the only form of wealth besides a house that most Koreans possessed, a relatively equal land distribution meant, in effect, a similar distribution of physical wealth.

Land reform, in an effect perhaps more important in the long run than the redistribution itself, destroyed the traditional class structure based on land–holdings. Before Japan took over Korea in 1910, a rigid class structure in which the hereditary upper class, called *yangban*, constituted perhaps 10 per cent of the total population restricted social mobility. The Japanese occupation weakened the position of these individuals when the Japanese colonial masters replaced them as the social elite. The post–liberation land reform performed the *coup de grâce* for the *yangban* class and the traditional class structure.

Since land reform in Korea was basically redistributive it may not have had any direct, positive effect on agricultural productivity[10]; but by putting an end to the traditional class structure it helped break down institutional barriers to economic and social mobility for the vast majority of Koreans and thus contributed to the rise of a new entrepreneurial class and the shared economic growth of subsequent years. Land reform in Korea also had forestalled potential agrarian unrest among poor tenant farmers, resulting in a politically pacified countryside during subsequent industrialisation (Wade and Kim, 1978). It also made possible the growth of import–substituting industries in the 1950s by destroying the landlord class which, as a powerful interest group, could have opposed the shift from primary commodity exports to import substitution in consumer goods industries which subsequently became export industries (Cheng, 1990).

Education and the Creation of Manpower

In 1945, Korea was a country of ill–educated people with 78 per cent of its adult population illiterate, but by 1960 the illiteracy rate had dropped to 28 per cent. This decrease came largely from a massive increase in school enrolment. In 1953, for instance, enrolments included 60 per cent of the elementary school age group (ages 6–11), 31 per cent of the middle school age group (ages 12–14), and 18 per cent of the high school age group (ages 16–17). These figures had risen to 86 per cent, 33 per cent, and 20 per cent, respectively, by 1960, and by 1964 Korea achieved virtually universal elementary education in a population that had been overwhelmingly illiterate less than two decades before (McGinn *et al*., 1980).

Korea succeeded in educating the masses of people in such a short period of time while holding per–student public expenditures on education lower than those in most developing countries. It could do so, in part, because the respect that teachers in Korea command made it easy to maintain strict discipline in the classroom even for

those not well trained by international standards (McGinn *et al*., 1980)[11] — another example of how informal institutions have a bearing on the effectiveness of formal institutions.

By the early 1960s, when the new political regime launched its programme of economic reform, Korea had succeeded in creating a pool of able and disciplined manpower, capable of benefiting rapidly from the short–term, on–the–job training carried out increasingly at factories as the demand for semi–skilled labour increased. A large pool of literate manpower thus served as an initial condition for successful economic reform which began bearing fruit in the form of rapid export expansion and economic growth[12].

Large Private Enterprises

When an economy exports traditional agricultural products and imports manufactured non–durable consumer goods, the commercial institutions engaged in expanding commerce and diverting agricultural products from domestic to international markets serve the economy well. As the economy makes the transition to manufacturing non–durable consumer goods at home, manufacturers will replace these commercial institutions. Whether the country makes a successful transition will thus depend on how successfully manufacturing institutions make the replacement and grow in strength.

In the early 1960s, the private enterprises that possessed entrepreneurial talents, organisational structure, personnel, facilities, and capital resources consisted mostly of the large firms that had grown up during the 1950s. A few of them go back to the Japanese colonial period (1910–45), but the majority of today's 30 largest enterprises, called the *chaebol*[13], had their origin and nurture only in 1945–60, preceding rapid industrialisation. Six started during the Japanese rule (1910–45), sixteen during the Rhee government (1948–60), and eight during the Park government (1961–79). The majority of the *chaebol* were thus in place, ready to respond to changes in economic policy that began in the early 1960s.

From 1953 to 1960, Korea had a low saving rate equal to 3 per cent of GNP and a poor, underdeveloped financial system. Given that situation, several policies undertaken by the government had a critical effect on the birth and growth of the *chaebol* by creating large sources of rents for them. The first and most important source involved their acquisition of vested properties which had formerly belonged to the Japanese (Cheng, 1990; Kang, 1993). These properties, which included operating plants and firms, land, infrastructure, and inventories, accounted for approximately 30 per cent of Korea's entire wealth at that time.

Distribution prices for these vested properties were set generally at the pre–1945 book values, substantially lower than market prices, and many of the properties went at even lower prices. Furthermore, the sales occurred in exchange for cash payment equal to only 10 per cent of the sales price, with instalment payments stretching over 15 years[14]. The high inflation that followed the sales further reduced the real burden

of payment and in many cases instalment payments were not even collected. When the sales ended in 1958, 37.7 per cent of the outstanding debts remained unpaid. Those who acquired vested properties thus realised significant windfall gains which became an important source of capital for a number of enterprises that later grew into such large conglomerates as Samsung, Lucky, and Hyundai (D.S. Cho, 1990).

The *chaebol* had a second source of rents in the preferential allocation of import licences and foreign exchange at an overvalued exchange rate. Overvaluation of the domestic currency and import restrictions obviously meant that the acquisition of foreign exchange at the official rate was highly profitable. Thus import trading became an important source of revenue for many of the *chaebol* and contributed to their capital accumulation.

The allocation of aid funds and materials furnished the third source. Acquisition of foreign aid, whether as aid dollars or in the form of raw materials, helped these firms greatly in building their industrial base and becoming *chaebol*. Furthermore, as recipients of foreign aid the *chaebol* could obtain government–arranged, long–term, low–interest bank loans similar to those associated with the sales of vested properties. In fact, with foreign aid and preferential credit the *chaebol* could build plants with their own equity equal to only 15–25 per cent of the total required capital, a process of capital accumulation further abetted by officially sanctioned monopolies.

Preferential access to bank loans provided the fourth source of rents, especially valuable in the prevailing high inflation and with the implied negative real interest rate. Access to bank loans interconnected with the other factors such as the acquisition of vested properties and the allocation of aid funds and materials[15].

If Korea had possessed well–developed capital markets, some of these unsavoury ways of accumulating capital might not have existed. Given that a competitive financial market requires a set of prudential regulatory institutions, which could not have been in place then in a country recovering from colonial occupation and a devastating war, what actually happened in Korea may have been a second–best solution which, one might even add, has not been uncommon in the history of capitalistic development[16].

Institutions for Rapid Industrialisation

If the 1950s saw the building of an institutional basis for capitalistic development, the early 1960s found the Korean economy ready to respond to the fundamentals of policy reform. Yet development during the 1960s and 1970s was not left to the dictates of markets alone[17]. Korea also introduced and tried new institutions to mobilise human and natural resources for rapid export expansion and economic growth. This may not have been unique, but Korea accomplished it with a distinguishing flexibility (Ranis, 1989; Rodrik, 1996)[18].

Hard State and Efficient Administration

The adoption of the fundamentals began with the devaluation of the Korean won in May 1964, followed by the implementation of a floating unitary exchange rate in March 1965. In return for a credit of US$9.3 million from the International Monetary Fund, Korea undertook a further series of reforms such as a tight monetary policy, increases in taxation, higher import duties on non–essential items, limits on international borrowing and greater export efforts. An interest–rate reform followed in the fall of 1965. According to Balassa (1980, 1981), these measures improved allocative efficiency by providing unbiased incentives to both exports and import substitutes and by minimising uncertainty over the structure of incentives.

This description illuminates only a part of the changes that took place after the military coup of 1961. First, these policy changes, to have effect, required certain institutional changes. Second, the industrial development that followed was not carried out solely by the private sector; direct government intervention designed to facilitate the progression of the economy through successive phases of industrial transformation strongly influenced it (Chang, 1993). The twin goals of the military coup of 16 May 1961 were to "make anti–communism, which has been considered only a superficial slogan, the foremost national policy" and to "solve the people's economic plight" (Choi, 1988, p. 4). They became the basis for reorganising the institutional structure of the government[19].

The government began with measures to centralise its political power. Upon the inauguration of the Third Republic on 17 December 1963, it dissolved the National Assembly and centralised political authority in the office of the president. To increase presidential power, four agencies were created under the direct control of the president — the Central Intelligence Agency, the National Security Council, the Council for Economics and Science, and the Board of Audit and Inspection — with the authority to obtain information relating to national security, the economy, and general administration. Although the Board of Audit and Inspection and the Central Intelligence Agency did not have direct control over economic policies, they could collect economic information and often intervened in the implementation of those policies.

Second, the state needed an effective instrument for carrying out its objectives. On 22 July 1961, it established the Economic Planning Board (EPB) as a strong and accountable agency for drafting and organising economic plans. The EPB took over various functions, such as budgeting, planning and statistical collection, from other agencies and ministries and, for better co–ordination of all the economic ministries, it ranked higher in the administrative hierarchy than a ministry.

A "hard" state with an efficient bureaucracy will not necessarily serve a country's developmental objectives. Such a state can easily turn predatory, as has happened in many LDCs. In Korea, however, external factors such as US aid policy and the necessity for attracting foreign investment checked those in power from using the state for their own personal gain (Cheng *et al.*, 1995). This cannot be the whole story, however,

because it embodies the assumption typical in the public choice literature that the state is a Mafia or leviathan whose sole purpose is to redistribute wealth and income. Such an assumption allows for neither the cultural norms of a society restraining the behaviour of political leaders nor heroic acts of particular individuals in determining the motivations of the state. To say, however, that Park Chung Hee, Lee Kuan Yew or, for that matter, Ferdinand Marcos did not leave any individual mark, whether good or bad, on how their governments functioned seems to contradict what most historical studies say about such charismatic leaders. In fact, most observers of the recent history of Korea will agree that, with his vision of and commitment to economic development, establishment of new institutions and adoption of largely correct economic policies, President Park Chung Hee played a critical role in the development of the Korean economy.

Accommodating Institutions for Industrial Development

In 1961–63 the government introduced several measures: direct subsidies and preferential loans to promote exports; tariff exemption on imports of raw materials used for manufacturing export products; the exemption of indirect taxes on exports and intermediate inputs used in export production; and a 50 per cent reduction in income tax on earnings from exports and tourism (Kim, 1991). The government also created a number of institutions to promote exports — for example KOTRA, the Korea Trade Promotion Corporation which, with its extensive overseas network, became an effective instrument[20].

Korea established the Monthly Export Promotion Conference, a unique institution, in December 1962; it became one of the most important administrative support mechanisms for exports. Regular participants included President Park Chung Hee, the Minister of the Economic Planning Board, the Minister of Trade and Industry, the Director of the KOTRA, the Chairman of the Korea Traders Association, and other public officials and private experts concerned with trade. It received routine reports on the progress of exports and the performance of exporting firms, and almost every month the president awarded medals and citations to successful businessmen. At each meeting of the conference, business representatives presented their problems and opportunities, and informed government officials, in front of the president, of the problems that businesses faced in dealing with government offices. The conference thus served not only as a forum in which the president could hector businesses to increase exports but also as one where the president took part in frank discussions about various problems, including bureaucratic red tape, that hindered the achievement of export targets. It filled an important function of institutions: collecting information and making it available to key decision makers.

The export–targeting system adopted in early 1962 initially set annual targets for total exports, but in the second half of the 1960s the system became more elaborate with annual targets for major commodity groups and destinations; for implementation, it assigned the former to related industrial associations and the latter to the Korean

embassies in the respective countries or regions. A "situation room" installed inside the Ministry of Commerce and Industry monitored export performance, compared it with the annual targets and reported regularly to the Monthly Export Promotion Conference with the president in attendance.

The Heavy and Chemical Industries (HCI) Promotion Plan of June 1973 formally began the promotion of six industries — steel, non–ferrous metals, machinery (including automobiles), shipbuilding, electronics and chemicals — with total investment of US$9.6 billion planned between 1973 and 1981. They would become future leading industries with expected exports to reach more than 50 per cent of total exports by 1980. In the early 1970s virtually no Korean firms possessed the technical or financial resources necessary to venture into any of them. Given the large–scale costs and inherent high risks, not many firms including the *chaebol* wanted to undertake such projects. The government hand–picked suitable firms and in fact coerced them with various incentives into undertaking the projects.

The HCI programme offers a clear case of close state and private sector co–operation to prepare the economy for changing international economic and political conditions. By the late 1960s, Korea had begun to face import restrictions on its light manufactured exports to the United States and other developed countries, as well as challenges from China and the developing countries in Southeast Asia in world markets for the same products. These changes prompted the government to promote the heavy and chemical industries for what it saw as the next phase of industrialisation[21]. The selection of industries came easily to top policy makers fully aware of how Japan had earlier taken the same path of industrial development with great success. Furthermore, experience in helping light manufacturing industries become internationally competitive gave them confidence in Korea's ability to establish the heavy and chemical industries as the next group of leading exporters.

To secure a domestic market for the new industries, the government re–instituted import restrictions and rolled back tax exemptions on imports of certain intermediate goods and capital equipment. It also granted higher investment tax credits to businesses which purchased domestically produced machines. The Tax Exemption and Reduction Law of 1975 provided a major package of tax incentives for investment in the designated industries, including tax holidays, investment tax credits, and accelerated depreciation. These incentives lowered the tax rate on the marginal return to capital by 10 to 15 percentage points, about a quarter of the tax (Kwack, 1984). The government also began investing heavily in related infrastructure: it built large–scale industrial parks; it overhauled educational and training systems to produce engineers and skilled workers; and it established research institutes to develop necessary technology. Between 1973 and 1980, the enrolment capacity of science and engineering colleges expanded from 26 000 to 58 000, total enrolment in technical high schools doubled and that in technical junior colleges increased more than five–fold. Six research institutes were established for science and technology, especially for the machinery, chemistry, and electronics sectors, with a corresponding increase in research and development expenditures financed by the government.

Dynamics of the Government–business Relationship

The Korean government's management of the economy during its transition growth differs from the role of government prescribed in mainstream neo–classical economics. Much more active, especially in its dealings with the *chaebol*, it guided and supported them while monitoring and controlling their activities to ensure that they used the resources and opportunities they received productively, for export expansion and economic growth. Thus in its relationship with the private sector the government used both discretionary power and incentives, the most important instrument being its control over the financial system and credit allocation[22].

Since the mid–1980s, however, the government–business relationship in Korea has changed as a result of several economic and political developments. First, having become large and successful the conglomerates have become less dependent on government credit allocation, while the financial liberalisation that began in the early 1980s has weakened official control over credit allocation. Second, with political liberalisation and the establishment of pluralistic politics the state has lost its institutional insulation and control over business. In fact, the danger now exists that the conglomerates will excessively influence the government and its policies in pursuit of their own narrow parochial interests. One of the challenges which Korea now faces lies less in curbing the power of the state than in establishing a state strong enough to stand up against powerful conglomerates while continuing economic and political liberalisation.

Conclusions

Institutions matter in economic development. As Winiecki (1992) would put it, "getting (at least some of) the institutions right" is as important as "getting the prices right". The experience of the transition economies clearly supports this conclusion, as does Korea's own experience of rapid economic development. Yet to be answered are the normative questions of what the optimal institutions are and how to institute them. In certain cases, private initiatives will suffice to bring about new institutions; but they have limits because institutions are inherently subject to externalities and the free–rider problem, and since the creation of institutions by private initiatives may take too long. The state may then have to involve itself directly to design and establish appropriate institutions.

Few would disagree with the general proposition that formal institutions such as laws, property rights, the enforcement of contracts, political stability, and an efficient bureaucracy are important for economic development and transition. The specific design of these institutions does remain at issue. Although some regard the institutional prerequisite for transition simply as that of establishing a reasonably well–enforced system of property rights (e.g. Wolf, 1992), what specific form it may actually take is

not all that obvious[23]. It is clear, however, that, given the complementarity between formal and informal institutions, the design of specific formal institutions cannot come entirely from some universal formula. Korea's experience offers a case in point.

This paper has stressed that *i)* Korea had already established a favourable institutional foundation by the time that it adopted fundamental policies of economic reform; and *ii)* the Korean state played a role more active than that prescribed in standard neo–classical economics, *inter alia* by creating institutions that could serve its developmental objectives[24]. The state's ability to play such a role depended in part on its institutional insulation from social groups (Haggard, 1994) — with a boost from the widely accepted Confucian ethos that a virtuous government leads the private sector even in economic matters (L.–J. Cho, 1994). This in turn allowed the government to pursue rather narrow developmental objectives instead of overcommitting itself to gain political support and then, unable to deliver, losing credibility, as happened too often in many other developing countries (Ranis, 1989).

Even with the state leading and the private sector willingly following, the economy would not have achieved rapid economic growth without the entrepreneurial and hard–working Korean people. The land reform and mass education undertaken during the 1950s deserve due credit for inculcating these societal virtues. Land reform enabled shared growth but, more importantly, it put an end to the traditional class structure. Together with mass education, it created a truly egalitarian society, an important ingredient for modern economic growth (Ranis, 1989). One cannot say with certainty how much of Korea's model can be transferred to other developing countries, because the effectiveness of transplanted formal institutions depends on existing informal institutions. Certainty does attach, however, to the importance of creating egalitarian initial conditions through both land reform and mass education, with its additional benefit of creating human capital.

Korea also has changed institutions and policies flexibly. Because the effectiveness of formal institutions depends on informal ones and because it is difficult to know *a priori* what formal arrangements will work, institutional flexibility makes it easier for a country to experiment and thus avoid being stuck with institutions that operate inefficiently. In Korea many of the institutions, especially the government–business relationship, that worked during its transition growth have become inappropriate as it prepares to join the ranks of developed countries. Korea now must find institutions appropriate to it as a developed, industrialised economy. The entire Korean experience teaches, especially to economists, that designing a successful reform package is a contextual exercise, requiring knowledge of a country's history and institutions. As Murrell (1991) remarked, carrying out any economic reform will require the skills and knowledge of philosophers and historians as well as economic theories and econometrics. A humbling lesson!

Notes

1. The author wishes to thank Abel Konan, Sumner La Croix, Rakesh Mohan, Augustine Tan and a number of participants at the conference for their valuable comments and suggestions.

2. Although there is no clear consensus on the definition of institutions, according to Nabli and Nugent (1989, p. 9) three basic characteristics appear to be common to most definitions of a social institution. These are *i)* rules and constraints, *ii)* the ability of the rules and constraints to govern relations among individuals and groups, and *iii)* their predictabiliity in the sense that the rules and constraints are understood as applicable in repeated and future situations.

3. Lin and Nugent (1995, p. 2304) point out that classical economists such as David Hume, Adam Smith, John Stuart Mill and modern development economists such as Lewis, Kuznets and Myrdal provided important insights on how institutions affected economic development. Until recently, however, much of the economics profession ignored institutions, focusing rather on "mathematically tractable topics".

4. Establishing new institutions means more than just creating new administrative bodies and passing new laws and regulations. For them to be effective in reducing transaction costs there must be also "institutional capital" — the accumulated institution–specific human capital of both the individuals who operate an institution and those subject to it (Schmieding, 1992).

5. These are the factors that create the demand for institutional change by creating gains to be realised by the change (Feeny, 1988).

6. According to Taylor (1994, p. 85), the blame for this institutional hiatus goes to the "Bretton Woods institutions and their favoured consultants" as their policies have little to do with putting institutional prerequisites for modern capitalism in place. (These are institutions supporting capital accumulation, an autonomous bureaucracy, and the state which creates and regulates markets.)

7. Establishing new institutions has distributional as well as efficiency implications. Bates (1989) shows that in Kenya those who controlled economic institutions regulating commercial farming used their political power to appropriate benefits and avoid the costs of economic change.

8. Kang (1993) and others have written about Korean economic growth "as if Korea — like Athena from the head of Zeus — sprang full–grown into development in the 1960s".

9. Land reform itself does not redistribute wealth from landlords to tenant farmers if it is accompanied with full compensation. In the case of Korea, however, a redistribution of wealth actually took place as the compensation amounted to perhaps only one–sixth to one–fourth of former land values.

10. Nevertheless, the 19th century development experience shows that sustained and widespread economic growth is likely only with "above–average equity" in land distribution and with the removal of political power from powerful resource–owning elites (Morris and Adelman, 1989).

11. Given that outlays on education have a delayed impact on output, many LDCs often postpone them when fiscal stringency is necessary (Fishlow, 1996). Education in Korea has suffered less from such fiscal stringency since Koreans attach a high value to education and, consequently, parents bear a large share of educational expenditures for their children. The parents' share of the cost of primary education ranged from about 40 to 50 per cent in 1977–85 while their share of expenditures for all other levels of education was about 80 per cent (Choo, 1990).

12. How education may have contributed to Korea's economic development still remains controversial. No direct empirical relationship between school enrolment and the rate of economic growth has been confirmed, and the role of education may in fact have been only that of "screening", "credentialism", and "socialisation" (McGinn *et al*., 1980). As a matter of fact, McGinn *et al*., who carried out a study of the role of education in Korea's economic development, conclude that "...education did play a critical role in the modernisation of Korea; it did this primarily by assisting a strong government with 'modernising' policies to impose its will upon the nation" (p. 241).

13. A *chaebol* may be defined as a large, diversified business group owned and managed by the founder of the group and his blood–related family members.

14. A typical example is the sale of the Chosun Spinning plant in Taegu to Kyung–Dong Sul, who later became the owner of the Taihan *chaebol*. The market price of the plant was estimated in excess of 3 billion won in 1947, but the official appraised price was only 700 million won. The plant was eventually sold at 360 million won, or 51 per cent of the appraised price, and the payment was arranged on an instalment basis over 15 years financed by low–interest bank loans. By 1962, 15 years later, the wholesale price index had increased 193 times, making the sale a virtual gift.

15. What the allocation of vested properties and preferential treatments accomplished is subject to disagreement. It may have created what Woo (1991) calls "political capitalists" in a country where "... politics, and not innovative drive, has always been the umbilical cord nurturing big business ...". Evidence clearly shows that many rent–seeking activities were involved in the allocation of the scarce resources and opportunities, and some of the rents went towards political ends, but what is also clear is that rents were not all squandered on political payoffs, luxury consumption or capital flight, as evidenced in the actual growth of the *chaebol*.

16. In his defence of the Mafia in post–Soviet Russia, Luttwak (1996) cites the unsavoury methods used in the post–World War II period by some of the present–day industrial giants of Italy, Japan, and Germany. "Black–marketeering, predatory buying, sub–standard manufacture, and efficient stealing enabled these hyena–entrepreneurs to accumulate the capital that enabled them to become honest wolves, and eventually productive cows" (p. 23). If this is what happened in the countries with a longer history of capitalism, what some of the budding entrepreneurs of Korea did in the 1950s seems clean and honourable by comparison.

17. Rodrik (1996) argues that Korea followed the "orthodox path" or the "Washington consensus" on policy reform by maintaining conservative fiscal policies and competitive exchange rates but diverged from the orthodox path in microeconomic interventions. He believes, as argued here, that the new orthodoxy in development thinking is based on a not entirely correct interpretation of the East Asian experience.

18. In discussing whether crisis brings about reform, Rodrik (1996) indirectly defines this institutional flexibility. He points out that Korean politicians have changed policies at the slightest hint of a crisis whereas Brazilian politicians have gone through several major crises before doing anything about the problem.

19. Whatever the true goals of the military coup might have been it did bring about changes in institutions. This Korean experience confirms North's hypothesis (1981) that institutional changes come from rulers rather than the ruled who always face the free–rider problem.

20. Another important factor contributing to Korea's export expansion was the absence of strong labour unions — a consequence of government repression — which could have pushed wages above market–clearing levels as in the Latin American economies (Fields and Wan, 1989). This clearly demonstrates the importance of institutional prerequisites for competitive labour markets.

21. Another important reason for the HCI drive was the government's desire to become more independent from the United States in the area of the military hardware (Stern *et al.*, 1995).

22. For analysis why and how such a role of government could have contributed positively to economic growth, see Lee (1992) and Haggard and Lee (1995).

23. In most Eastern European countries which enacted new civil and commercial codes or put prewar legislation back in force, the demand for legal services seems to have dropped drastically or risen less than expected. This casts a doubt on the argument that clear enforcement of property rights and contracts is a prerequisite to the functioning market and supports the hypothesis that a relatively simple market does not need much in terms of judicially enforced property rights as some simple homegrown informal mechanisms will suffice (Rapaczynski, 1996).

24. Whether such a role has in fact contributed to Korea's economic development remains very controversial. In their study of Korea's heavy and chemical industry drive Stern *et al.* (1995, p. 190) argue that such an activist role by government does not seem to have done better than an "unfettered market economy" might have.

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Challenges to the Newly Emerging Economies: A Reinterpretation of the Growth Experience of Asian NICS

Jungho Yoo

Introduction

In the 1960s and 1970s a group of developing countries in Asia — Hong Kong, Korea, Singapore and Chinese Taipei — began to grow rapidly. Few had expected it because they were neither particularly well endowed with natural resources nor did they have advanced science and technology. Yet they grew and industrialised beyond all expectation. They came collectively to be called the newly industrialising countries (NICs). Their performance presents both hopes and challenges to the newly emerging economies (NEEs). They have shown that countries endowed with little else besides unskilled workers can grow and industrialise, but no firm agreement exists on how to explain the rapid growth of the Asian NICs or what lessons to draw from their experience.

The neo–classical view holds that minimisation of price distortion, a reliance on market mechanisms, and orientation towards international trade furnished the main reasons for the NICs' unprecedentedly rapid economic growth. The revisionist view attributes their extraordinary achievement not to more freely operating markets but to government intervention in the market. Indeed, the governments of the NICs have had extensive involvement in resource allocation. This paper reviews Korea's case in detail. Regarding Chinese Taipei, Rodrik (1995) observed that it "... kept its tax rates much higher than Hong Kong but pushed the investors in the desired direction through the widespread use of tax incentives. These incentives were fine–tuned to a degree rarely seen in other countries". Government intervention was minimal in Hong Kong, the exception not considered seriously, perhaps because it is a city. Popularising the revisionist view, Amsden says, "... not only has Korea not gotten relative prices right, it has deliberately gotten them 'wrong' "; she judges that this policy could succeed because, in a reciprocal relationship between the state and firms, the government

exacted certain performance standards in return for subsidies. She generalises, "[t]he more reciprocity that characterises state–firm relations in these countries, the higher the speed of economic growth" (Amsden, 1989, pp. 139, 146)[1].

The revisionist view appears to have theoretical support in recently developed trade theories that explicitly incorporate such features as imperfect competition and increasing returns to scale, and from theories of endogenous growth. The new theories neither prescribe free trade nor recommend government intervention as a principle. An export subsidy to an oligopolist domestic firm could increase the country's welfare. The presence of increasing returns to scale in an industry combined with technology spillovers may justify subsidies to industries as they could permanently alter the economy's comparative advantage and raise its real income. Opening trade could slow down growth if it leads to specialisation in sectors other than the "growth sector". Rodrik asserts that "... the new literature is far from having yielded robust conclusions ... more often than not it has led to a bewildering array of special cases and an embarrassingly rich set of possible outcomes from policy intervention" (Rodrik, 1995).

The new theories do not determine whether the neo–classical view or the revisionist view lies closer to the truth. Meanwhile, we must make sure that we have the facts right on the growth experience of the NICs and that important and relevant facts are not overlooked in interpreting the experience. Proponents of the revisionist view often cite the Korean experience as supporting evidence, but seldom make a distinction between the policies of the 1960s and those of the 1970s, which were very different in nature. This paper briefly reviews Korea's growth, industrialisation and government policies, then provides a critical assessment of the revisionist view in light of that experience, first by clarifying the difference between government policies in the two decades and then by evaluating the effects of the Heavy and Chemical Industry Policy of the 1970s. It then considers the influence of the world market on a country's growth and industrialisation, with a focus on whether the potential gains from interaction with the world market have increased over time. From the United Kingdom to the NICs, the pace of growth and industrialisation has certainly accelerated. Good reasons exist to believe that bigger gains can emerge today than in the days of early industrialisation, enabling countries that actively engage in trade and other interactions with the world market to grow and industrialise fast. If this is the case, rapid industrialisation of the NICs need not be as surprising as it appears.

The Korean Experience during the 1960s and 1970s

The Export Promotion Policy of the 1960s

Korea was in chaos after independence from Japanese rule in 1945. The 1950s began with the three–year Korean War, with the rest of the decade spent in recovering from the destruction; the economy grew at an average annual rate of about 4 per cent. Industrial policy encouraged import substitution in non–durable consumer goods and

their inputs. The Korean won was overvalued, quotas and other non–tariff barriers severely restricted imports, and foreign exchange transactions remained under strict regulation.

From 1963 the growth rate more than doubled, averaging 9.8 per cent per annum for the rest of the decade and 8 per cent in the 1970s. The Korean won was devalued twice and many incentives, including widely used tax exemptions, were introduced for exporters. From 1962 until 1973, they could reduce by 50 per cent their tax liabilities on income from exports. Until 1975, they could accelerate depreciation of their fixed capital for tax purposes. Imported intermediate inputs enjoyed tariff exemption when used by exporters or their domestic suppliers (this became a tariff rebate system in 1974). Preferential loans to exporters offered another important incentive. They had automatic access to bank loans, usually at much lower interest rates than on ordinary loans, amidst persistent excess demand for money and often negative real interest rates. The interest rate differential between preferential and ordinary loans (eliminated in the early 1980s) reached as much as 18 per cent in the mid–1960s. Still other incentives such as export–import link schemes and reduced rates on public utilities also found use and, for a short while in the early 1960s, there was even a direct subsidy per dollar of exports. The Korea Trade Promotion Corporation (KOTRA), established in 1964, provided exporters with information on foreign markets.

The Heavy and Chemical Industry (HCI) Policy of the 1970s

In the 1970s, the government switched to the HCI policy, intended to promote the development of "important" or "key" industries — iron and steel, non–ferrous metals, shipbuilding, general machinery, chemicals and electronics. The switch was made for several reasons, the most important of which was security. In 1971, the United States reduced ground troops stationed in Korea by one–third and Korea saw this as the beginning of impending full withdrawal. The government felt a need to build up certain "key" industries for defence. It also perceived the rapid increases in China's and "second tier" NICs' exports, and rising protectionism in industrial countries against labour–intensive products, as major threats to Korea's export expansion. Growing trade deficits played a role as well. Exports rose faster than imports in the 1960s but trade deficits became ever larger because the export base remained much smaller than that of imports. The accepted wisdom at that time held that large trade deficits arose from a heavy dependence on imports, itself the consequence of underdeveloped heavy and chemical industries.

The government pursued the HCI policy vigorously, mobilising all policy instruments at its disposal. The corporate tax system provided various tax breaks for qualified firms in the "key" industries. Typical examples included exemptions from direct tax, tax holidays, special depreciation of fixed capital, and temporary investment tax credits. Trade policy restricted imports of foreign goods competing with the products of the favoured "key" industries, although exporters had continued access to foreign goods at international prices through the tariff rebate system. The government's most

powerful tool, however, involved "policy loans" through which it allocated funds among different investment projects. A National Investment Fund established in 1974 financed numerous large–scale projects, and the government could direct the commercial banks it then owned to allocate policy loans by projects and amounts. Since the loans carried interest rates lower than the inflation rate for most of the 1970s, this amounted to major discrimination in favour of the "key" industries promoted by the HCI policy and against others.

Doubts about the Revisionist View

The central proposition of the revisionist view asserts that government somehow can speed up the pace of growth and industrialisation by altering the resource allocation of the market or even by distorting such prices as interest and exchange rates. Proponents often cite Korea as the prime supporting example, yet such citations seldom distinguish between the policies of the 1960s and those of the 1970s, and they take all policies adopted by the Korean government as the reasons for Korea's success. Such accounts sometimes give the impression that the policies of the 1970s explain the country's success in the export expansion of the 1960s. One must more closely compare the policies of the two decades and evaluate the HCI policy of the 1970s, the outstanding example of successful government intervention in the revisionist view.

Government Policy in the 1960s and 1970s

Throughout the 1960s and 1970s, the Korean government's intervention in the economy had always been extensive and pervasive until the announcement of a "Comprehensive Stabilisation Programme" in 1979 discontinued the HCI policy, but the content of economic policies differed significantly between the two decades. In the 1960s nearly all had the goal of export expansion. In the 1970s, the objective shifted to promotion of "key" industries, an attempt to transplant to Korea a more "advanced industrial structure". To pursue this goal, the government became directly involved in resource allocation at the sector, industry and even firm levels. The 1980s differed from both the previous decades as the government opted for a greater reliance on the market, less government intervention and more market opening.

The export drive of the 1960s worked better than the HCI policy in the 1970s for two reasons. First, it was result–oriented and not concerned with the process. The private sector made the effort to achieve the result, namely better export performance. In contrast, policy in the 1970s was process–oriented. The government attempted to achieve its goal by promoting certain industries. It became deeply involved in picking the "right" industries, supplying them with the "right" amounts of investment and complementary factors such as skilled workers at the "right" time and place, and so on. In effect, the government tried to achieve the result by replacing private sector effort.

The second reason relates to the incentive structure. The incentives provided to exporters under the export promotion policy of the 1960s had the effect of offsetting the anti–export bias of existing protectionist measures. One study concludes, after quantification of the effects of protectionist and export promotion policy measures at the time, that the incentives for firms to sell their products in the domestic market or to export were almost equal in the late 1960s. In other words, Korean exporters operated in a free–trade–like environment (Westphal and Kim, 1982).

If this was the case in the 1960s, the incentive system could not have remained neutral in the 1970s when industrial policy strongly encouraged import substitution. It must have had a bias in favour of domestic sales. Korean exports expanded faster and the economy performed better in the 1960s, when the private sector faced a neutral incentive system between exports and domestic sales, than in the 1970s when the government made an extensive attempt to substitute itself for the private sector and created a bias for domestic sales.

The Effects of the HCI Policy

The effects of the HCI policy on the economy should have been predictable. On the one hand, the new investments in the heavy and chemical industries could not promptly add to the flow of goods available to the economy as they required long gestation periods. Perhaps more importantly, import substitution, viable only under high protective barriers, could not contribute to the foreign exchange earnings necessary to finance imports. On the other hand, insufficient investment elsewhere in manufacturing meant absolute or relative reductions in capacity and productivity. These two factors together created excess demand for some products of the neglected industries — especially agricultural products, everyday consumer necessities, and other essential commodities. Their prices rose sharply, and the government responded with price controls. Predictably, shortages and black markets developed. The massive investments in heavy and chemical industries led to a large increase in the demand for skilled labour. This, together with the boom in Korean construction business in the Middle East, raised wage rates for skilled workers and all other workers as well.

Export growth started to decelerate sharply in real terms in 1977 and export volume declined absolutely in 1979. Consequently, the economy suddenly slowed down and registered negative growth of –4.8 per cent in 1980. Unfavourable exogenous factors also intervened, such as the second oil crisis, political uncertainty following the assassination of President Park (both in 1979) and cold weather in the summer of 1980, which reduced agricultural output for the year; but these factors cannot explain the worsening economic performance in the preceding years, 1978 and 1979, nor the decline in exports in real terms in 1979.

It is instructive to compare Chinese Taipei's and Korea's export performances. In the mid–1970s, Chinese Taipei had the product composition of exports most similar to Korea's. The two shared other similarities, such as their stages of economic

development and their resource–poor characteristics, cultural background and so on. An important difference was that Chinese Taipei did not employ the kind of interventionist industrial policy that Korea used. Korea's share of OECD imports of manufactures declined in the late 1970s, while Chinese Taipei's continued to increase, as Table 1 shows. In Korea, the "light" industries, as contrasted with those favoured by the HCI policy, experienced the declining share — and this explains the faltering export performance in the late 1970s. Significantly, those industries the policy discriminated against lost competitiveness in OECD markets *vis–à–vis* Chinese Taipei and the loss was not recouped by a better performance of the favoured heavy and chemical industries compared to their Chinese Taipei counterparts. In both groups of manufactured goods Korea's export performance lagged.

Table 1. **Korea's and Chinese Taipei's Market Shares in OECD Imports of Manufactures**
(Percentages)

	Total manufactures		Light manufactures		Heavy and chemical manufactures	
	Korea	Chinese Taipei	Korea	Chinese Taipei	Korea	Chinese Taipei
1974	0.86	0.96	1.59	1.73	0.45	0.56
1975	0.82	0.90	1.64	1.70	0.34	0.45
1976	1.15	1.08	2.23	1.96	0.51	0.59
1977	1.21	1.14	2.23	1.99	0.58	0.65
1978	1.41	1.44	2.76	2.56	0.67	0.84
1979	1.30	1.44	2.53	2.56	0.69	0.89
1980	1.17	1.43	2.24	2.70	0.69	0.86
1981	1.42	1.75	2.70	3.20	0.83	1.12
1982	1.51	1.85	2.83	3.42	0.92	1.19
1983	1.69	2.14	2.86	3.84	1.18	1.45
1984	1.85	2.46	3.21	4.30	1.26	1.73
1985	1.87	2.46	3.21	4.39	1.28	1.71
1986	2.03	2.57	3.29	4.36	1.44	1.76
1987	2.40	2.87	3.64	4.52	1.80	2.11

Source: Yoo (1990), p. 96.

In April 1979, the Korean government announced a Comprehensive Stabilisation Programme that attempted to retract and correct the excesses in the HCI policy. The programme had its basis in a recognition that industrial policies had caused many difficulties in all parts of the economy: macroeconomic management, the operations of small and large firms in both favoured and neglected industries, the daily lives of average or low–income families, competition in international markets, and the country's international credit standing[2].

Historical Experience

By the end of the 1980s, barely 30 years since expanding exports began to transform the Korean economy, the manufacturing sector produced 30 per cent or so of the economy's total output and employed more than a quarter of the labour force. Since the weight of the sector seldom becomes much greater in other countries, one may call the Korean economy at the time "industrialised". The pace of growth and structural transformation had been exceptionally rapid by the standard of the advanced industrial countries. This was not unique to Korea but more or less the same for other Asian NICs.

The proponents of the revisionist view attempt to find the reason for this in something peculiarly Asian. Yet while these countries all occupy the same region of the world geographically, they also occupy the same time, that is, their growth and industrialisation took place in the same period — and all actively engage in international trade. These common characteristics bring attention to the world market and its influence on a country's economic growth. The influence of the world market deserves more attention than it has received, especially in looking for the reasons for the extraordinary success of the Asian NICs, unthinkable without international trade. If the potential gains from international trade (well recognised, preached by economics since its beginning, and not the point stressed here) have *increased* over time, the "East Asian miracle" can more readily find explanation — and if the means of interaction with the world market other than trade increased in number, the explanation would become still easier.

What data and information provide indications of how the influence of the world market on an economy's performance has changed over time? First, consider the length of time required for industrialisation since its first occurrence in the United Kingdom. "Industrialisation" here simply refers operationally to the agricultural sector's fall and the manufacturing sector's rise in importance to the economy — specifically, a drop in agriculture's share in employment from more than 60 per cent to less than 20 per cent and an increase in manufacturing's share from about 10 per cent to about 30 per cent, which was the change in Korea's employment structure during the three decades since the early 1960s.

Table 2 reports sectoral employment share data for a few selected countries at two dates: *i)* the supposed year in which the country began industrialisation (for the United States and Korea) or the earliest year for which employment data could be obtained; and *ii)* the year in which the country became industrialised, as defined operationally above. Table 3, which covers the few countries for which comparable data were available, gives an idea of how output structures changed; the two dates here are: *i)* the year in which agriculture produced about one–third of GNP and manufacturing about 10 per cent; and *ii)* the year in which agriculture's share fell to less than 10 per cent and that of manufacturing reached around 30 per cent.

Table 2. **Proportion of Workers Employed in Sectors**
(Percentages)

Country	Year	Agriculture	Manufacturing
United Kingdom	1841	23.6	37.6
	1861	18.8	38.6
France	1856	51.7	21.9
	1962	20.0	28.2
Germany	1882	47.5	27.2
	1950	18.7	32.9
United States	1850	63.6	16.4
	1930	21.5	22.7
	(1940)	(17.0)	(20.1)
Japan	1920	53.8	16.4
	1970	19.3	26.2
Chinese Taipei	1952	56.1	12.4
	1980	19.5	32.6
Korea	1963	63.0	7.9
	1989	19.6	27.8

Notes:

1. "Agriculture" includes agriculture, forestry and fishery.
2. For the UK, Germany and France "manufacturing" includes gas, water, electricity and sanitary service, except for France, 1856.
3. For the USA, 1850 "manufacturing" includes construction.
4. For the UK, France, Germany, Japan and Chinese Taipei the earlier date is the earliest date for which statistics are available.

Sources: National Office of Statistics, Korea (1995), US Bureau of the Census (1949), (1976), Mitchell and Deane (1971), Mitchell (1983), Council for Economic Planning and Development, Chinese Taipei (1984), Japan Statistical Association (1987, 1988).

Table 3. **Proportion of GDP (GNP) Produced by Sectors**
(Percentages)

Country	Year	Agriculture	Manufacturing
United States	1839	34.6	10.3
	1929	9.8	25.2
Japan	1900	37.7	16.1
	1968	10.1	29.7
Chinese Taipei	1952	35.9	10.9
	1980	9.2	34.2
Korea	1960	36.8	13.8
	1989	9.6	31.0

Notes

1. For the United States, "GDP" in 1839 is "realised private production income by industries" in US Bureau of the Census (1949), and in 1929 national income in US Bureau of the Census (1976).
2. Japan's manufacturing in 1900 includes mining.

Sources: The same as for Table 2.

Obviously, Table 2 cannot show the precise length of time required for industrialisation but merely gives rough indications, and the picture that emerges shows the pace of industrialisation accelerating over time. Korea's industrialisation took a little less than 30 years. Chinese Taipei's also took about 30 years, from the start of structural transformation somewhat earlier than 1952 until 1980. Japan started to industrialise before 1920 and the process took about 60 years, from the 1910s to 1970; World War II may have had an adverse effect. In the United States, it seems reasonable to judge that the economy had become industrialised when the Great Depression began and that the process took about 80 years. For the United Kingdom, France and Germany the earlier beginning dates are more difficult to guess. Nevertheless, it seems certain that France's industrialisation must have taken more than 100 years because agriculture's share of total employment was about 52 per cent in 1856 and fell to 20 per cent in 1962. Germany may have started later than France. If the start date was 1850, industrialisation took about 100 years; if it was 1860, it took about 90 years. The United Kingdom's industrialisation process may have taken less time but hardly much less than a century, given that the first industrial revolution began with the wave of technological innovations in the 1860s.

This acceleration likely did not occur because the people were more intelligent and industrious in the countries that developed later. What enabled Korea and other NICs with little accumulated capital and technology to compress into three decades the century or longer that the advanced industrial countries had needed to achieve comparable economic transformation? The primary reason resides in their interaction with the rest of the world. Korea and Chinese Taipei reaped the textbook benefits from international trade. Their manufacturing sectors grew as exports of labour–

intensive products requiring simple production technology expanded while they imported capital goods and intermediate inputs. If Korea or other NICs had needed to produce domestically the capital goods, intermediate inputs, and industrial raw materials necessary for export production, rapid growth and transformation would not have been possible. Thus, the interaction with the world market provided an indispensable advantage for rapid economic growth.

The world market was also opened up for exports, an advantage of the NICs not available to the advanced industrial countries in their time. When the industrial countries of the West underwent the "modern economic growth" of Simon Kuznets (1966), high costs of transportation and communication, not to mention border trade barriers, segmented the world market. In fact, for the industrial countries growth of the world market and that of the domestic markets were synonymous. The NICs' own production capacity placed practically the most important limit on how much they could export, because the world market can absorb much more than a developing country can supply. Korea's exports accounted for less than 0.1 per cent of total world exports in 1965, less than 0.3 per cent in 1970, and less than 1 per cent in 1980, when Korea was well on its way toward industrialisation.

The NICs had another very important advantage in the availability of foreign savings. Japan had grown rapidly, also thanks to the world market, but at a much slower pace — probably because, while it borrowed science and technology, Japan did not borrow much foreign savings in the process of capital accumulation. Japan's current account deficit rose above 3 per cent of its GNP only twice during the years of industrialisation and never exceeded 5 per cent (Japan Statistical Association, 1988, Tables 13–3 and 13–4). The NICs' current account deficits have been much larger. Korea's exceeded 10 per cent of GNP in the late 1960s and early 1970s.

The ASEAN countries and China have repeated the NICs' growth experience, but at a faster pace. They are "borrowing" not only science and technology, capital equipment, and foreign savings but also foreign firms. In contrast, until quite recently most countries in Latin America and Africa did not as significantly engage in trade or other interactions with the world market, and their economies either stagnated or shrank. Thus, the fortunes of countries drastically diverged depending on whether they took advantage of the world market.

All these differing experiences seem to indicate that the gains a country can obtain from interacting with the world market have *increased* over time, which explains why the pace of growth and industrialisation in the NICs could much exceed that of the advanced industrial countries. To disregard this factor in explaining the success or miracle of the Asian NICs leads to overrating the importance of other factors. In this sense, the proponents of the revisionist view, in their attempts to find the explanation of the East Asian miracle as something peculiarly Asian, gave more than due credit to government intervention and distortion of the market mechanism.

In fact, the opposite seems true. If government interventionism really accounts for the NICs' success, Korea should exceed Chinese Taipei in economic performance, and Chinese Taipei should be ahead of Singapore or Hong Kong. The actual ranking of the performance by per capita GNP among the four suggests the opposite. Hong Kong was not an exception as the revisionist would view it. Rather, it seems to have benefited most from the interaction with the world market by being more open than other NICs to the world market. At least in the Korean experience of growth and industrialisation, the revisionist view does not seem vindicated.

Challenges

The obvious message for NEEs aspiring to grow and industrialise as rapidly as the NICs is to use fully the opportunities the world market offers and benefit as much as possible from gains in trade and other interactions with the world market. The rapid growth and industrialisation of Korea and other NICs came from this source. The importance of the message increases with recognition that the potential gains from interaction with the world market have increased over time, for two reasons. First, the size of the world market has grown compared to the size of a developing economy; the international division of labour through trade can now provide much greater benefits than it did to countries which industrialised earlier. Foreign savings available through commercial borrowing or foreign investments also have increased. A developing country can accumulate capital, unconstrained by the availability of domestic savings, at a much faster pace than the advanced industrial countries could during their industrialisation.

This casts doubts on the revisionist attribution to government intervention of the Asian NICs' unprecedentedly rapid growth and industrialisation. Not all the policies pursued were conducive to industrial growth. Korea's export promotion policy in the 1960s worked well because the government avoided involvement in resource allocation; policy provided entrepreneurs with a neutral incentive between domestic sales and exports, as export incentives offset the anti–export bias created by the protectionist policies of the 1950s still in place. In contrast, the HCI policy in the 1970s, a typical industrial targeting scheme, did not work. The administration of President Park which started it also put an end to it.

The neo–classical view that the market worked wonders when allowed to operate with minimum price distortion with an orientation towards international trade seems to be valid and gets support from the hypothesis that the potential gains from interaction with the world market have increased over time. The NEEs' performance will depend not on how closely they imitate the NICs' policies but on how fully they make use of the world market.

The challenge for both the NICs and NEEs now concerns how to use the world market as the world becomes increasingly borderless in an economic sense, as government power to control borders weakens and as resources with international mobility indeed move. Planning will become increasingly difficult and a greater reliance on the market mechanism inevitable in resource allocation. The government sooner or later lags behind the private sector in manpower and information; resources can no longer be assumed to be fixed as their international mobility rises; and, as the international division of labour widens and deepens while the inter–industry links among domestic industries loosen, it becomes harder to foresee what would result from planning decisions. The information necessary for intelligent interventions will increase at an exponential rate, making intervention less justified and greater individual freedom of choice inevitable.

Direct management of the economy by government needs replacement by indirect management through rules. A relatively simple matter for industrial countries in the West, especially those with long traditions of common law systems and a market economy, this task becomes more daunting for the NICs as well as the NEEs. It involves not simply reducing the role or functions of government but establishing fair and transparent rules of the game to govern competition in the market, the outcome of which in turn will determine resource allocation.

This is the biggest challenge for Korea and others. The NICs may one day look back upon the past 30 years of rapid growth and industrialisation as a relatively easy phase of economic growth. Relatively low wages and imports from abroad of what they lacked domestically enabled them to expand exports and grow faster than others. Although the fairness and transparency of the rules of the game were not satisfactory, it did not matter much. As wages rise thanks to growth and industrialisation, and as the world economy becomes increasingly borderless, the rules of the game in a society will matter a great deal, if they do not already. Fair and transparent rules cannot simply be imported from abroad but have to be developed from within. Thus, how successfully government reduces its role and allows markets operating under such rules to replace it will critically determine economic performance in the borderless world of the future.

The most difficult part of the challenge requires that government reduce and change its own role, which will substantially reduce the power and privileges of its bureaucrats. It must accomplish this in a societal environment where most people, including the opinion leaders, do not adequately appreciate that the invisible hand of the market is the feeding hand, or that the international division of labour enabled rapid growth and industrialisation.

Notes

1. The World Bank (1993) does not take an outright revisionist view but sympathises with it. While it says that promotion of specific industries generally did not work, it gives some credit for the rapid growth of Asian NICs to the careful policy interventions of government. According to the Bank, governments improved on market–based competition by creating contests that combine competition with the benefits of co–operation between government and the private sector. In Japan and Korea, which had high–quality civil services, the contests were brought about by a deliberation council through which the government distributed rewards such as access to credit or foreign exchange. See World Bank (1993), pp. 11, 24.

2. For more detailed discussion of the effects of the HCI policy, see Stern *et al*. (1995), Chapter 4.

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Anatomy of Reform in Two Large Developing Countries: China and India

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Introduction

Since World War II, countries in Asia have successively generated high rates of GDP growth and strong convergence with European and North American living standards. The "Four Tigers" — Korea, Chinese Taipei, Singapore, and Hong Kong — quickly followed Japan's outstanding growth performance in the 1950s and 1960s; the newly industrialising economies of Thailand, Malaysia and Indonesia emulated them in the 1980s and 1990s. All succeeded in accumulating and improving their physical and human capital, and they took advantage of the generally favourable external market environment to produce real GDP growth rates that often exceeded 10 per cent per annum and averaged nearly 6 per cent for the entire group from 1960 to 1992.

Until 1978, the region's two largest countries — India and China, together comprising almost 40 per cent of the world's population in 1990 — faced bleak futures. Both had dysfunctional systems for allocating resources and lacked the basic institutions necessary to support high economic growth. China began its first wave of market–based reforms in 1978, resulting in annual GDP growth rates close to 10 per cent. India began major reforms in 1991 and its GDP growth has slowly risen to over 6 per cent in 1994–96. If its government continues to introduce new rounds of market–based reforms, India could well have the same growth experience as China. The potential of these two economies with 2 billion people raises a critical question: How will their progress affect the world economy?

Yet this question is also premature. Both countries face intertwined issues of political succession and the sustainability of economic reforms, on which continued high growth depends. China must deal with an uncertain change in political leadership, unbalanced growth across urban and rural areas, and the need for new waves of reforms.

India faces the challenges of continuing reforms under a splintered coalition government, high population growth rates for the next two decades and a critical need to bring more of its rural population into the reform process.

India instituted major reforms between July 1991 and 1994. While the initial wave has raised GDP growth rates, a much–needed second wave could stall from a lack of consensus among political parties on the future direction of reforms. India does, however, have the advantage of a late mover. As Alexander Gerschenkron (1962) so aptly pointed out, a backward country has the advantage of learning from others' mistakes and can modify others' successes to local circumstances. While both India and China can learn much from the sustained reform processes in other fast–growing Asian countries, China may also offer special lessons for India. If country size (as measured by population) affects the process or goals of economic reform, then India may look to China as the only other comparable country to undergo fundamental economic reform. This paper will analyse the reforms in China and India and then ask what India can learn from China. While the reform process in China has several unique features that do not transfer well to India (or to Russia, another large country), India could benefit from a close examination of China's dual–track reforms.

What, then, do we know about the impact of country size on the process and goals of economic development and reform? Surprisingly little. In their review of the literature, Perkins and Syrquin (1989) concluded that population size significantly affected the performance and structure of a country. Compared to small and medium–sized countries, large ones generally have a smaller share of GDP in foreign trade; trade is concentrated more on manufactures than on raw materials; their GDP growth rates are somewhat higher; and their manufacturing sectors are less specialised. The studies summarised by Perkins and Syrquin may have limited value, however, as most are flawed by a failure to control for other relevant differences between large and small countries. For example, they group countries with centrally planned economies (China and the former USSR) with market economies (United States and Japan) and highly regulated economies (India). Empirical studies comparing this group of large countries with a sample of smaller countries usually failed to control adequately for the type of economic system or to distinguish sufficiently between developed and developing large countries. Thus they generally failed to isolate the effect of size on economic growth and development. Given the small sample of large countries (five to seven observations), one can question whether reliable conclusions could ever be drawn from statistical studies of this type.

The dearth of rigorous empirical work forces the policy maker to focus more closely on case studies and the insights of economic theory. What aspects of economic theory point to the impact of size on the goals and process of development and reform? First, the problem of co–ordinating decision makers and allocating resources clearly increases in complexity the larger the country's population. Centralised systems of information collection and processing become less efficient, requiring a decentralisation of certain activities to provincial and local governments. A large country will often

find reform more difficult to initiate than a small country with a less complex governance system. Second, a large country can more fully exploit economies of scale. This implies, consistent with Perkins and Syrquin's empirical results, that large countries likely will have lower foreign trade ratios than small ones and that internal trade can operate as much as an engine of growth as foreign trade. Third, large countries are unlikely to form natural economic units, because political, military, and cultural forces also have shaped their history and configuration. Some geographic areas within a country may constitute separate economies or have closer ties to a foreign economy. In the long run, migration may mitigate regional disparities and produce income convergence, but in the short run regional disparities may generate political and social problems. Finally, large countries may find that "growth poles" emerge within them which draw people and resources from other regions. They can be magnets of economic growth as well as the source of numerous social and political tensions.

China: Transition to High Economic Growth

China's successful growth performance has dramatically transformed its economic structure. The proportion of the labour force in agriculture dropped from 71 per cent in 1978 to 56 per cent in 1993, and the proportion of gross industrial output produced by state–owned enterprises (SOEs) declined from 78 per cent to 43 per cent in the same period. The integration of China into the world economy has been equally dramatic: trade (exports plus imports) reached US$28 billion in 1993 compared to US$2 billion in 1983. Human development indicators, including life expectancy, literacy, infant mortality, per capita income, and the incidence of poverty, all show dramatic improvements in line with the rapid economic growth.

Sources of Growth

Five factors have had particular importance in generating high growth in China. Elaborated in more detail below, they are:

— three favourable initial conditions;

— integration into the global economy;

— strong saving behaviour;

— political effects of the earlier leftist mass campaigns; and

— the Chinese diaspora.

Of the five, only two (China's integration into the global economy and its high saving rate) offer general lessons for economic reforms. The other three (initial conditions, the Chinese diaspora, and the debilitating mass campaigns) were specific to China's circumstances.

The first of the three favourable initial conditions concerned the enormous pool of workers employed in low–productivity agriculture. New industrial enterprises could grow by pulling surplus workers from the agricultural sector. While individual workers from SOEs did shift to the new non–state sector, the aggregate decline in the share of agricultural workers matches the aggregate growth of the non–state sector as a share of the labour force. Most workers in SOEs chose not to shift to non–state enterprises because SOEs offered more generous wages and social protection, largely through the huge subsidies and other benefits that the state continued to bestow on the SOEs. They provided generous pensions and heavily subsidised housing, medical coverage, child care, food and recreational facilities. Peasants, by contrast, received none of these benefits and consumed only one–third of the goods and services enjoyed by urban residents. They were only too glad to shift out of low–income agricultural activities to the new, higher–income jobs in the non–state sector, notably in the township and village enterprises (TVEs). This movement of low–productivity agricultural labour into higher–productivity TVE activities became an important determinant of Chinese growth. Woo (1996) shows that the productivity gain from it served as the chief source of higher aggregate production efficiency [total factor productivity (TFP)] after 1978. TVEs also are simply more efficient than SOEs, probably because they do not receive budget subsidies and preferential bank loans, and thus face hard budget constraints.

The second initial condition involved the limited extent of China's central planning. Qian and Xu (1993) noted that around 25 million commodities entered the Soviet economic plans, while China included only around 1 200. Third, unlike Poland, Russia and indeed India, China did not initiate reforms during a period of macroeconomic imbalance or a severe external debt crisis requiring an austerity programme. Poland and Russia had to tame inflation and restructure their fully employed economies simultaneously; China could initiate reforms while the TVEs employed idle agricultural labour.

The integration of China into the global economy operated through several channels. Access to international markets for labour–intensive manufactured goods accelerated the movement of labour out of low–productivity agriculture into high–productivity industry. China's improved political ties with the West and its (somewhat rocky) adoption of intellectual property rights enabled it to buy modern technology, some of it previously denied. Finally, foreign direct investment (FDI) increased the capital stock, transferred new technology, made available global distribution networks and introduced domestic firms to more efficient management techniques.

Household saving in China, unusually high even by East Asian standards, amounts to about 23 per cent of disposable income versus 21 per cent in Japan, 18 per cent in Chinese Taipei, 16 per cent in Belgium, 13 per cent in West Germany and 8 per cent in the United States (World Bank, 1990, Table 4.9). The flow of household saving into the formal financial system (the state banks and rural credit co–operatives) has

risen steadily from 3.4 per cent of GDP in 1980 to 11.7 per cent in 1991. From this total, loans to collectively owned and individually owned enterprises took 3.5 percentage points while loans to SOEs and the government took 8.2 percentage points.

The high household saving rate reduced inflation in the Chinese economy in two ways. First, the flow of savings through the banks reduced the need to print money to meet the excessive resource demand of the SOE sector. As the official *China Daily* reported:

> "Loans are continuing to be injected to enterprises which are obviously at the edge of bankruptcy ... Some loans have been used to pay wages, which have a pretty name: 'loans to keep social stability' ... According to PBOC [People's Bank of China, the central bank], 46 per cent of fresh bank loans last year created unmarketable goods"[1].

Thus, the use of China's high saving rates to preserve macroeconomic balance and social stability has forced China to sacrifice growth rates even higher than the impressive ones generated so far. Second, the high saving rate reduced inflation through a high demand for money, until recently the only form of financial asset available to households in China. The large inflation–damping effect appeared in the rise of the M2 to GNP ratio from 38 per cent in 1979 to 106 per cent in 1992. This ratio now appears to be levelling off as the agricultural economy becomes fully monetised and as new financial instruments emerge.

The fourth factor behind China's success in the 1980s grew out of the two disastrous leftist campaigns, the Great Leap Forward (1958–61) and the Cultural Revolution (1966–76). Fairbank (1987, p. 320) reported that the Cultural Revolution produced a 60 per cent "purge rate among the party officials". When Deng Xiaoping transferred a significant amount of economic policy–making power to the provinces, the central ministerial and party apparatus was too exhausted politically to resist his decentralisation.

Family ties between mainland and overseas Chinese furnished the fifth factor. The explosive growth of the Special Economic Zones (SEZs) in southern China came from a wholesale movement of labour–intensive industries from Hong Kong and Chinese Taipei as they lost their comparative advantage in these industries. Compared with alternative sites in Southeast Asia, China had proximity, lower wages and fewer language difficulties. Family connections greatly reduced the transaction costs of investment by providing reliable local supervisors, inside information on the enforcement of regulations, and contacts with local authorities.

The Dual–track Reform Strategy

Chinese reformers capitalised on favourable factors and conditions by employing a "dual–track" approach: the co–existence of a market track and a plan track[2]. The dual–track approach pervaded almost every aspect of policy making: sectoral reform,

price deregulation, enterprise restructuring, regional development, trade promotion, foreign exchange management, centre–provincial fiscal arrangements and domestic currency issuance.

Dual–track Production and Pricing

China launched the dual–track approach at the end of 1978 with rapid and comprehensive liberalisation of the agricultural sector while the industrial sector remained under traditional central planning management. It disbanded the agriculture communes by distributing the land to the peasants, who received 15–year, freely tradable land leases as grants. It raised state procurement prices for agricultural products and allowed free markets for agricultural products. Farmers gained a large range of production freedom — only 5 per cent of their production in 1993 was set by the state plan. In 1984, this "dual–track" arrangement was extended to industrial goods, with state procurement quotas for consumer goods set much lower than for producer goods. Planned production fell from over 90 per cent of total industrial output value in 1978 to 5 per cent in 1993.

The typical process of dual–price transition opened the free market, kept state supply unchanged at the (lower) plan price, and adjusted the plan price incrementally to approach the market price. Consumer subsidies (or tax deductions for firms) accompanied each price increase, and the supply offered at the plan price was usually reduced over time. When the "final punch" for convergence of the two tracks was delivered, the importance of the supply offered at the plan price had generally become negligible. For example, the dual–track transition of food prices began in 1979, and the supply available at the plan price had decreased to about 20 per cent of total food consumption in 1992. As a result, the convergence of food prices in 1992 produced no discernible shock.

A similar process occurred in the foreign exchange market. The unification of the official exchange rate and the swap market exchange rate occurred at the end of 1993 when the differential between the two rates was about 50 per cent. By this time, only 20 per cent of foreign exchange transactions remained subject to the official exchange rate. The rationed component of foreign exchange sales did not fall — instead, the new track expanded dramatically.

Dual–track Ownership Structure

Reform of the ownership structure has been the most important dual–track reform. China's rapid growth has come mainly from the dynamic development of the "new track non–state sector" — private and semi–private enterprises, community–owned rural industrial enterprises, foreign joint ventures and individual businesses. Foreign investment, especially overseas Chinese investment, has provided an important driving force for changes in ownership structure. From 1979 to mid–1994, foreigners invested US$82.3 billion in 210 000 projects. FDI amounted to US$25.3 billion in 1993. About

68 per cent of the total foreign direct investment has come from Hong Kong, Macao and Chinese Taipei, and overseas Chinese accounted for a considerable portion of the investment from the United States and Japan (which ranked third and fourth, respectively, as sources).

The ownership reform started when household farming replaced the collective "Commune" system (1979–83). This transformed agriculture, which accounted for over 30 per cent of GDP in 1979, into a *de facto* private economic activity. The surplus product from the resulting agricultural boom together with the labour released by the rise in agricultural productivity enabled small private businesses (e.g. transportation, retailing and crafts) and community–owned industrial enterprises (TVEs) to develop. Local governments owned and controlled the TVEs until the 1984 relaxation of restrictions on private ownership of enterprises. An enterprise could receive TVE classification only after approval by the local government. A TVE pays lower taxes than a private enterprise. From 1984 onward, the terms of approval and supervision of TVEs varied greatly across provinces, with much vagueness about ownership and control, a great variety of TVEs and changes in their nature — all of which make precise description of the TVEs difficult. Most important, they represent *localised socialism* compared to the centralised socialism embodied by the SOEs. SOEs and TVEs therefore differ fundamentally in character although both are publicly owned and subject to government regulations.

TVEs bear classification as non–state enterprises because they face hard budget constraints. They cannot keep borrowing to cover their losses; bankrupt TVEs are not the state's responsibility. The SOEs, on the other hand, have repeatedly forced the state to print more money to bail them out. Competition does not shut down bad SOEs, and TVEs survive as the dynamic forces in the country's growth. The TVE organisational structure has evolved particularly fast because TVEs, unlike SOEs, can implement innovations without the approval of the central government. The locally initiated development of the "shareholding collective system" in TVEs aptly demonstrates this feature. This flexibility in organisational structure has enabled TVEs to move closer to best international practices in corporate governance and accounts for their leadership in exports and foreign exchange earnings. In a nutshell, the TVEs, unlike the SOEs, live by the market. During the last economic downturn, the number of industrial TVEs fell from 7.7 million in 1988 to 7.2 million in 1990 while the number of industrial SOEs increased from 99 000 to 104 000. The dynamism of TVEs has given rise to claims that China has "grown out of the plan", but the SOE sector has actually retained its relative standing in employment: 18 per cent of the labour force in both 1978 and 1993. There were 35 million more SOE workers in 1993 than in 1978!

Dual–track Regional Development

In 1980, China designated four southern coastal cities (Shantou, Shenzhen, Xiamen, and Zhuhai) as Special Economic Zones (SEZs); Hainan province became the fifth in 1988. The SEZs received autonomy to experiment with new institutions

and reforms. Most importantly, they obtained exemption from many of the regulations governing foreign investment. Their phenomenal growth spurred other regions to demand economic liberalisation as well. An additional 20 cities subsequently received approval as "economic and technological development districts", with some of the SEZ privileges.

Dual–track regional development served two purposes. First, the specified regions attracted foreign direct investment into export–oriented activities, thereby allowing them to become export platforms for multinational enterprises seeking inexpensive labour. Second, they empowered the government to liberalise other, more general aspects of the trading system, including the freedom of individual enterprises to engage directly in trade transactions and the ability of trade–oriented enterprises to buy and sell foreign exchange.

The opening of the economy to foreign trade and investment became the engine behind China's export boom. By 1993 exports had risen to 17 per cent of GDP compared with 4 per cent in 1984. TVEs accounted for 44 per cent of exports and foreign–funded enterprises for 27 per cent, making the non–state sector China's main foreign exchange earner. Thus, China has replicated the success of the East and Southeast Asian economies where the non–state sectors generated export–led growth by exploiting their countries' comparative advantage in labour–intensive goods.

Fiscal and Financial Reforms

As in other East Asian countries, the state has retained strong fiscal and financial control, and reforms have occurred in an ebb and flow process with subsidiary entities. The decentralisation reforms produced three critical institutional innovations:

The Budgetary Contracting System (BCS)[3]

This served as the major device for reshaping central and provincial fiscal relations (Wong *et al.*, 1995). Under the BCS, the central government shares revenues (taxes and profit remittances) with local governments in the following way:

— the central and provincial governments collect revenues on separate tax bases according to the administrative subordinate relationship, i.e. different governments tax different payers; and

— each provincial government signs a contract with the central government specifying revenue remittances for several years. For provinces running budget deficits, the contract specifies subsidies to be paid by the central to the provincial governments.

The Contract Responsibility System (CRS) for State Enterprises

Under this system, SOEs pay contracted amounts of taxes and profits to the state and retain the remainder. In principle, as long as SOEs can deliver the contracted remittances, the government will not interfere with their operations.

Direct Borrowing

Since 1985, bank loans have replaced state grants to local governments and SOEs for operating funds and fixed asset investments. The proportion of SOE funds raised externally has risen dramatically in the last decade. Since 1991, local governments and SOEs have had permission to borrow directly from workers, households and other financial institutions. Similarly, the local branches of the central bank and the state specialised banks also have some discretion in formulating their lending policies[4].

The Political Necessity for a Gradual Reform Strategy

A gradual reform process has emerged, not so much from an explicit strategy but as the result of political deadlock or compromises between hard–liners and reformers within the Communist Party of China (CPC), as well as the general lack of consensus in the society at large. Early recognition of this point came from Hamrin (1984), who identified three factions within the CPC in 1978: the "neo–Maoist conservatives" exemplified by Hua Guofeng, Li Xiannian and Ye Jianying; the "orthodox reformers" exemplified by Chen Yun and Peng Zhen; and the "pragmatic reformers" exemplified by Deng Xiaoping, Hu Yaobang and Zhao Ziyang. Over time, the first two groups merged because their members "were unwilling to grant Deng and his successors an open mandate to depart further from China's Marxist–Leninist heritage" (Hamrin, 1984).

Chen Yun enunciated the "bird cage economy" doctrine, a metaphor subsequently used by hard–liners. The central plan is the cage and the bird the economy. The premise says that without central planning production will be chaotic, i.e. without the cage the bird will fly away. The amount of market activities tolerable to keep the economy working is analogous to how much swinging the cage needs to create the illusion of greater space that will keep the bird happy. The reformers, on the other hand, believe that only a market economy will promote long–term economic development.

This absence of consensus has persisted throughout the reform period. The dual–track strategy served not only as a pragmatic approach to facilitate economic change but also to buy time for the emergence of a consensus. "Muddling through" has not been a strategy, as some have claimed, but the result of a lack of political consensus. With these tensions constantly present, it is not surprising that the CPC has continually altered its stated goals for economic management. These changes reflect partly

experience under the reforms and partly the shifting balance of power between competing factions with different views of the economy. The CPC's desired economic mechanism evolved from "a planned economy based on the law of exchange value" before 1979, to a "planned economy that is supplemented by market regulations" in 1979–84, to a "planned commodity economy" in 1985–88, and (after two more changes) to "a socialist market economy with Chinese characteristics" in 1992[5]. The 1992 statement had particular significance because it finally dropped the word "plan" from official rhetoric. The phrase "socialism with Chinese characteristics" implicitly denies the universality of socialism and hence rejects the planning model of the Soviet bloc with state ownership of production units as the norm.

The demise of the Russian Communist Party in 1991 enabled Chinese reformers to restart the economic liberalisation suspended by the hard–liners who dominated policymaking after the 1989 Tiananmen incident. The process of marketisation and internationalisation of the Chinese economy accelerated because the Soviet experience convinced CPC leaders that "centralised control, enforced egalitarianism, international isolation and ideological dogmatism" were suicidal (Garver, 1993)[6]. The CPC has even allowed some degree of privatisation of SOEs[7]. In November 1993, the CPC required SOEs to adopt new operating mechanisms, allowing large and medium–sized SOEs to experiment with corporatisation, while smaller ones tested management contracts, partnerships, or direct privatisation. By late 1995 it had become politically acceptable for government officials to suggest publicly that state ownership of only the 1 000 largest existing SOEs would satisfy the political definition of "socialism with Chinese characteristics"[8].

The lack of consensus among CPC leaders on reforms led to the "dual–track" approach as a way to proceed without dismantling existing firms and institutions tied to socialism. It was feasible because the government could partially insulate the two tracks from one another. As reform proceeded, government efforts usually switched to phasing out or reforming the plan track. Despite their moderate success, the plan track has continued to thrive and reforms have had only limited impact in some cases, e.g. SOE employment. The same lack of consensus on reforms is present in the mid–1990s among India's major political parties.

India: Making the Transition to High Growth?

After independence in 1947, the Government of India committed to economic self–reliance and an economic development strategy with strong social welfare features. It prided itself on restraining the operation of multinational companies and maintaining low levels of import dependence and foreign indebtedness. It either owned and operated or highly regulated major industrial firms. Despite several rounds of limited reforms in the 1970s and 1980s, Indian growth rates lagged far behind those in East and Southeast Asia. When Narasimha Rao [Congress (I)] became Prime Minister in June 1991, macroeconomic indicators had reached crisis dimensions. The fiscal deficit

of the central government for fiscal year 1990–91 reached 8 per cent of GDP; inflation raged at 13.6 per cent; and foreign exchange reserves could purchase only two weeks' imports. With a severe balance–of–payments crisis looming, India signed a structural adjustment agreement with the IMF in July 1991 and initiated a major round of reforms.

The Adjustment Measures Implemented from July 1991 to January 1996

The Indian reform programme began with a bang, with decisive steps on macroeconomic stabilisation and exchange rate management, and important liberalisation measures relating to industry, public finance and foreign trade and investment.

Industrial Licensing

On the eve of the 1991 reforms, Indian policies in the industrial sector did not differ much from the situation in 1970, aptly characterised by Bhagwati and Desai (1970):

> "The allocations of foreign exchange and 'basic' materials (such as steel) to the sectors, industries, firms, and plants within these broad sectors could ... have been left to the market mechanism, instead of being controlled (with severely adverse impact on efficiency) rigidly and without any economic rationale. As it turned out, Indian economic policies in the industrial sector degenerated into an extravagant display of bureaucratic controls and restrictions, with these means turning into *de facto* ends."

In July 1991, India's Finance Minister, Manmohan Singh, took a giant step towards ending these misguided policies by announcing the removal of most industrial licensing requirements and the lifting of location and capacity restrictions on industry. The new policy reduced the number of industrial sectors reserved for public sector investment from 17 to eight; abolished requirements for government approval of domestic investment in all but 18 sensitive areas specified on a "negative list"; and granted automatic approval of foreign technology agreements and foreign direct investment of up to 51 per cent of equity in 34 sectors, specified on a "positive list". In April 1992, it added computer software to the positive list and in April 1993 it removed three important sectors from the negative list. The new industry policy has greatly expanded the scope of operations available to the private sector in India.

Exchange Rate Policy

Two major devaluations in July 1991, amounting to a total of approximately 20 per cent, reflected the seriousness of the balance–of–payments problem. After a further devaluation in March 1993, India moved in August 1994 to Article VIII status in the International Monetary Fund which committed it not to place any restriction on

international payments and receipts on the current account. From October 1994, money deposited by non–resident Indians in the Rupee Depository Scheme could be repatriated fully by 1996–97.

Public Finance

The Tax Reform "Chelliah" Committee issued its report in January 1993. In response, the government initiated a comprehensive programme of tax reform which included cutting tariffs, reducing corporate income taxes and converting excise taxes into a modified version of a value–added tax (VAT). In April 1994, the service sector came within the tax net[9]. Over the next two years the scope of the VAT system was broadened to create a larger tax base.

Foreign Trade

Between 1990 and 1994, the government reduced its average tariff on imports from 87 per cent to 33 per cent. In 1994, it virtually eliminated import duties on oil, cotton, and sugar. The 1995–96 budget cut the maximum tariff rate to 50 per cent and reduced tariffs on many imported inputs used in high–growth industries. The 1996–97 budget proposes cutting numerous tariffs on raw material inputs, but also mandates a 2 per cent special customs duty on most imports. Some of the duty reductions did not reduce effective protection for Indian industry, as the government also cut excise taxes on domestically made goods.

Foreign Investment

Foreign investment in India had been controlled since 1973 by the Foreign Exchange Regulation Act (FERA). In January 1993, FERA was amended, opening to private firms sectors once reserved for public investment. The International Finance Corporation responded by providing US$118 million in loans and equity to one of the first private–sector financed power plants, a US$300 million gas and naphtha plant in Andhra Pradesh. Foreign investors' confidence rose further when New Delhi offered to guarantee payments to the US power company Enron for its US$3 billion western Maharashtra power plant. In 1995, however, the Maharashtra State Government repudiated the Enron contract after construction had already begun. Enron and the state government entered arbitration and the project was put back on track after Enron made concessions. Other questions also have arisen concerning how open various sectors really are to FDI. In 1995 Kentucky Fried Chicken restaurants were closed by state regulators alleging health code violations, and the Indian government turned down a proposed joint venture by Singapore Airlines (40 per cent ownership) and Tata Industries (60 per cent ownership) to form a new international and domestic airline.

Between August 1991 and March 1996, almost US$21 billion in FDI was approved, although realised FDI amounted to less than 50 per cent of approvals. Companies from the United States and the United Kingdom have dominated these flows (47 per cent of the 1993–94 total), with little interest shown so far by Japanese companies. As in China, foreign investment has been concentrated in just a few states and regions. Portfolio capital inflows generated by foreign institutional investors and country funds were opened in 1993–94, with US$1.5 billion raised in the first year. Changes in regulations governing international financial instruments have since produced widely varying portfolio inflows.

Financial Sector

In November 1991, the Narasimham Committee submitted a root–and–branch reform report on India's financial system. Regarding bank investments and credit, its report proposed that the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) be reduced; that banks no longer be required to hold government securities; that directed credit programmes be gradually phased out; that interest rates be market–determined; and that banks in good standing be permitted to raise capital through public issues. The report also proposed that regulatory distinctions between private and public banks be removed; that foreign banks be allowed to enter the Indian financial services market; and that the structure of the banking industry be changed, with three or four banks designated as international banks and national banks reduced from 28 to eight or ten.

The government has implemented some of these recommendations, reducing the CRR from 25 per cent to 14 per cent and the SLR from 38.5 per cent to 25 per cent. RBI–mandated minimum interest rates on loans have gradually fallen for small loans and disappeared for large loans. In the insurance sector, where two large state firms have monopolies on life and general insurance, the government has prepared for private entrants by setting up a regulatory commission, but it has not yet granted foreign or domestic firms permission to enter the market.

Public Enterprises and Privatisation

While the government has announced that unprofitable public sector enterprises can no longer rely on the government to make up their losses, it has not initiated direct privatisation and still covers the losses of most public sector enterprises. It has sold shares in public sector units, but mostly to government–owned financial institutions. Of the 230 public sector enterprises managed by the central government, only 31 had been subject to any divestment by the end of 1994, with approximately 8 per cent of each firm's equity offered. Because the government intends 51 per cent of equity to remain in state hands, this leaves large scope for further divestment. A fourth round of public sector divestiture sales ended in 1994, with shares worth US$733 million sold in six public sector enterprises. The Finance Minister in the newly elected

(June 1996) United Front coalition government, P. Chidambaram, has announced general plans for three rounds of divestment in 1996–97, with government forecasts of proceeds set at Rs50 billion. States are also beginning sales of state land and state enterprises to raise funds for public enterprise restructuring. Several state governments are contracting out the management of power distribution to private companies as a prelude to full privatisation in the power sector.

The Initial Economic Fruits of the 1991–96 Reforms and Future Reforms

Writing in July 1993, two years into the structural adjustment programme, Bhagwati and Srinivasan (1993) concluded that "in the absence of new steps, the returns from the existing reforms may be meagre". They advocated a strategy of "cascading reforms" because they reasoned that "[a] *blitzkrieg* of reforming measures represents a moving target for opponents, making it more difficult to concentrate criticism than when the target is static". While the initial wave of reforms has not been rolled back, the flow of new reform measures slowed to a trickle in 1995 and 1996. The United Front's budget for FY 1996/97 contained few significant reform measures. The return from the first five years of reform has already been substantial, however. Approved and realised FDI has steadily increased; numerous multinational corporations are investigating operations in India; and the Indian states have begun to compete for FDI. National GDP growth rates increased to 6.3 per cent in FY 1994/95 and 6.2 per cent in 1995/96. Despite these encouraging signs, the Indian economy remains plagued by pervasive structural distortions.

The Octroi *System*

India still does not have *internal* free trade. The *octroi* border–tax system, which allows an Indian state to charge a tax when goods cross its border, is essentially local protectionism and a significant impediment to the development of an integrated national market. This distortion has special importance because inter–regional trade can spark growth in a large country as much as foreign trade. The central government, whose job clearly includes the maintenance of a unified national market, should take the lead in replacing the *octroi* system with more efficient ways of financing provincial expenditure.

Priority Sectors, Mandatory Loans and Restructuring of Sick Companies

The over–regulation of India's financial institutions has put them in dire straits, as evidenced by their poor loan recovery rates. The banks perform poorly for a key reason — they must lend much of their funds to state–identified "priority sectors", selected according to bureaucratically determined social development criteria. In response to the worsening financial situation of firms in priority sectors, the government passed the Sick Industrial Companies Act (SICA) in 1985. SICA created the Board for

Industrial and Financial Reconstruction (BIFR), a quasi–judicial body staffed largely by personnel from the Ministry of Finance, to evaluate and facilitate the rehabilitation of chronically loss–making industrial enterprises. The BIFR may determine that a sick firm be closed and workers retrenched. In practice, however, the BIFR became an apologist for the inefficient enterprises it was supposed to turn around. BIFR often served as the vehicle for industrialists to gain access to tax concessions, additional government subsidies, and infusions of public capital. Many industrialists purposely siphoned funds or supplies in order to obtain these benefits to rehabilitate their "sick" firms.

SICA was amended in December 1991 to empower BIFR to order closure of public firms judged to be financially non–viable. Because government officers rather than elected politicians staff BIFR, its expanded mandate allows the government a certain degree of insulation from unpopular decisions concerning closure or privatisation. Restructuring of loss–making public enterprises proceeds at a glacial pace, however, with only about 5 per cent of 2 207 cases referred to BIFR. Many processed cases are under appeal in the courts. The failure to close loss–making government enterprises impedes the restructuring of government spending to emphasise human resource development, critical for long–run growth. The next round of reforms should make restructuring the BIFR a priority.

Industrial Relations

Another of India's most damaging institutional flaws lies in the labour market rigidity produced by the labour unions and the legal framework governing industrial relations. Under the Industrial Disputes Act an enterprise employing more than 100 workers cannot lay off workers without approval of the relevant state government. Since politicians in a democratic society rarely will agree to the dismissal of their constituents, medium and large Indian firms find it almost impossible to restructure as the economy grows and undergoes structural transformation. The unintended fallout from this labour market rigidity inhibits employment creation. Firms show exceeding reluctance to expand employment when demand for their products is high because they do not want to be stuck with too many workers if it falls. New firms hesitate to enter the market. The law thus presents a clear case of excessive government regulation which, in the name of protecting labour currently employed in manufacturing, actually impedes the employment of surplus labour in low–productivity agriculture.

The Industrial Disputes Act works against not only employment creation but also the long–run interests of union members. It undermines productive industrial relations and democratic unionism by failing to specify how workers should select their trade union representatives and how employers should recognise them. The absence of secret ballot elections or specified criteria for the recognition of a union as a collective bargaining partner invite political manipulation and organised crime into Indian unionism (Candland, 1994). While significant debate has taken place on revising the Industrial Disputes Act, the previous Congress government did not make its reform a priority and little progress is expected under the United Front government.

The Political Dimensions of Economic Policy Making

A history of competitive political parties reaching back nearly a century[10] and a tradition of socialist rhetoric extending over more than five decades have made Indian economic restructuring particularly contentious. The combination of institutions developed over decades of competitive elections and political parties laying claim in various ways to economic nationalism has spawned strong interest groups opposed to rapid economic restructuring. The main opposition party, the Hindu fundamentalist Bharatiya Janata Party, while broadly pro–reform in its rhetoric, has gained popular support by espousing a *swadeshi* (self–reliant) economic philosophy, and has earned financial support from Indian businesses threatened by international economic competition.

India's political system is built on federalism. State governments have direct responsibility for such important subjects as sales taxes, agriculture and irrigation, power, road transport, health and education. Control of the state and central governments by rival parties often hampers co–ordination between the two. The two levels of government share some functions. For example, regulation of land ownership is a state responsibility while industrial licensing and labour legislation are shared. The central government may lift industrial licensing requirements in a given industry but state governments, under the Urban Land Ceiling Act of 1976, control the use of urban land by industry. Thus the central government cannot implement many of its economic reform programmes without the support of some state governments. Until the reform process diffuses more fully among state governments, critical reforms will languish.

The lack of consensus on reform within India's government mirrors that in the Chinese government during the 1980s and 1990s. Could India use China's dual–track system to continue with reforms? This would encounter difficulty in some, even many instances because India has a long–established tradition of the rule of law; yet it still has promise. For example, because restrictive labour laws apply to new as well as to old firms, improved labour relations require direct, nation–wide reform applicable to all sectors; no dual–track substitute can exist — but the central government could easily use the dual–track system with co–operative state governments to create Indian versions of SEZs. Federal legislation offering SEZ privileges to states undertaking a required set of complementary reforms could spur needed reform in some states and generate new waves of export–oriented FDI.

Conclusion

The secret of Chinese economic growth lies in economic reforms structured to allow the non–state sector to grow. The opening to international trade and foreign capital has greatly fostered fast growth. The rapidly expanding non–state sector has alleviated poverty by attracting Chinese peasants out of their rural desperation into higher–paying, labour–intensive manufacturing activities.

Why has the Indian private sector not boomed and accomplished what Karl Marx identified as the historical obligation of capitalism: the rescue of the peasants from the "idiocy of rural life"? Ironically, the non–state sector in capitalist India faces more economic regulation than the non–state sector in socialist China. The shackles operate through three differences between the two systems.

— First, the non–state sector in China pays virtually no taxes. It expanded from less than 20 per cent of GDP in 1978 to more than 66 per cent today, yet its tax payments have fallen from 1.2 per cent of GDP in 1985 to 0.5 per cent in 1993.

— Second, the Chinese non–state sector faces no restrictions on hiring and firing workers. In India, a firm with more than 100 workers faces stringent regulations on the dismissal of workers. Since a fast–growing economy is also a fast–changing economy, firms must have freedom to restructure quickly to meet new situations. India's heavy regulation of the labour market tragically discourages the expansion of existing firms and the establishment of new ones. India's protection of urban unionised workers — about 9 per cent of the labour force — has meant economic discrimination against the remaining 91 per cent. The ability to hire and fire freely in China has allowed the quick development of the non–state sector, and the hire–only restriction in India has stymied the growth of its private sector.

— Third, China's non–state sector faces few restrictions on the inflow of foreign capital and technology and pays no tariffs on intermediate inputs if they are used to produce exports. In essence, a large part of China's non–state sector serves as an export platform for multinational corporations. India, on the other hand, has refused to embrace its comparative advantage in labour–intensive manufactured products. Its unwillingness to allow part of its private sector to co–operate with multinational corporations in this way provides an important reason why many Indian peasants (62 per cent of the labour force in 1990) remain in agriculture.

India certainly can tap the same forces that have propelled China's economic growth. Through industrial deregulation and greater integration into the world economy, it can just as easily mobilise its private sector to absorb low–productivity agricultural labour into higher–productivity industrial and commercial activities[11]. The mushrooming of labour–intensive manufacturing activities becomes the key outcome of economic liberalisation in a developing, populous country. Well–executed economic reform, transferring workers from agriculture to industry, does not necessarily hurt the poor. Since the beginning of economic reform in Indonesia in 1984, higher demand for labour in manufacturing has raised the real wage and improved income distribution (Woo, Glassburner and Nasution, 1994). The Indonesian experience confirms that a large country implementing labour–intensive industrialisation via market signals, as was done earlier in Korea and Chinese Taipei, can generate the same prosperous, equitable outcome.

As in China, it would not be fatal if political constraints prevent dismantling the Indian SOEs quickly. Given India's vast labour surplus, the private industrial sector can expand without requiring the SOEs to shed workers. The critical policy for SOEs requires hardening their soft budget constraints to forestall their generating price instability (via the monetisation of government deficits).

The Indian diaspora and its foreign capital relax the capital constraint on infrastructure investment and private investment. In fact, India possesses three advantages over China in attracting FDI. It has a well–defined and well–tried system of political succession, a stable political process that tends to make for a more stable civil order. It also has a functioning legal system that clearly defines and protects private property. While the current unfortunate combination of anti–business laws and a judiciary system that actually works according to the words of the laws has adversely affected India, the legal infrastructure exists to enforce more efficient laws. Finally, immense benefits derive from the linguistic advantage of widespread knowledge of the English language within the population.

Perhaps China's most important lesson for India is that a populous continental country does not naturally grow more slowly. The Chinese experience completely demolishes the idea that India's "Hindu rate of growth" persists because the nation has development problems on a much greater scale than most other countries, because its greater social diversity causes more frequent political disputes that ultimately hinder growth, or some combination of the two. The case for a liberal economic order that originated with the rise of Korea, Singapore and Chinese Taipei, and which China and Indonesia verified in the 1990s, has the same strength for India as for other Asian countries.

Notes

1. *China Daily* (1993), p. 4.

2. China's success has led some analysts to conclude that the dual–track strategy is superior to the big–bang reform strategy in transforming centrally planned economies to market economies. See Sachs and Woo (1994) and Woo (1994) for critical assessments of this conclusion.

3. New reforms in taxation and revenue sharing are being attempted. They include the redistribution of tax revenues by categories (instead of by taxpayers) between the central and provincial governments. Their purpose is to increase the share of central revenue, rebuild the revenue transfer mechanism, and redefine the expenditure responsibilities between the centre and provincial governments.

4. The local branches of state banks (the central bank and the state commercial banks) are to a great extent "truly local". The officials of local banks are part of a larger hierarchy, usually appointed by higher supervisors within the bank system. In reality, they are directly under the supervision of local authorities and benefit from local prosperity. They have generally done their best to meet the loan requests of local officials and local SOEs, albeit while somewhat constrained by central regulations. See Woo (1998).

5. The "law of exchange value" is from the Marxian (labour–based) theory of value, and "commodity economy" refers to an economy in the early stage of economic development where the emphasis should be on increasing production rather than on equality, so that concessions to market incentives may be necessary.

6. For example, on 1 January 1994, the currency was made convertible for most current account transactions and a new market–compatible tax system was introduced.

7. For a review of the failure of China's SOE reforms, see Fan *et al.* (1996) and Woo *et al.* (1994).

8. *China Daily* (1995); *Financial Times* (1995*a*); *Financial Times* (1995*b*); and *Wall Street Journal* (1995).

9. In March 1994, the Central Board of Direct Taxes issued a circular which brought "service contracts" of Rs 10 000 or more in a given fiscal year under a 2 per cent tax.

10. Indian electoral competition pre–dates independence considerably. The British Viceroy's Legislative Council and Provincial Legislatures, under the 1861 Indian Councils Act, were partially elected. The Indian National Congress was founded in 1885 and Indian political parties began competing in elections to provincial legislatures under the Government of India Act of 1919.

11. See Sachs (1994) for a detailed liberalisation package.

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