Sources of Growth and the Role of Government in the Development of the East Asian Economies

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I. Introduction

In the past twenty to thirty years, only a few of the more than 140 developing countries in the world have achieved the status of being a newly industrializing economy (NIE). The growth and industrialization of the East Asian NIEs—in particular, Hong Kong, South Korea (henceforth Korea), Taiwan, and Singapore—during this period, as well as the rise of Japan following World War II which attained developed-country status and went on to become an economic superpower in the 1980s and 1990s have been, by all standards, spectacular. In contrast, the developing economies of Latin America—some of which were at a higher stage of development than the East Asian NIEs at the turn of the century (Argentina is one example of this)—and Africa have not witnessed as impressive performances.

During the decade of the 1970s, many developing countries experienced robust growth, but for most of them, the high growth rates lasted for only five to ten years, and the expansion could not be sustained. Thus, not all the developing countries that experienced rapid growth in the 1970s were able to move forward and attain NIE status. The East Asian developing countries (henceforth East Asia), as well as Japan, were, however, able to maintain the momentum for economic growth in the 1980s, despite poor external conditions, and they have in fact con-

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[**Seoul Journal of Economics** 1994, Vol. 7, No. 2]

tinued with this momentum into the 1990s.

This remarkable feat of high and sustained growth in East Asia in the past two decades and in Japan following World War II leads one to wonder how and why such growth has occurred in only a small number of countries located mostly in Asia? What was the mechanism or factors behind the sustained high growth of these countries?

In trying to answer these questions, one is also confronted with the issue of the role of government. On the one hand, there is Hong Kong where the level of government intervention has been minimal and, on the other hand, there are Korea and Taiwan where the governments intervened in terms of establishing a targeted industrial policy and directing credit allocation to specific sectors and/or industries. There are divergent views on the effects of such government involvement on economic activities, and the experiences of East Asia and Japan do not as yet provide clear-cut answers to this question. As noted by the lively discussion on this issue in the literature and among development economists, the debate is far from over.

This paper addresses these questions and is based on a panel discussion at the First Seoul Journal of Economics International Symposium held on November 1993. Scholars whose expertise lies in the experiences of developing economies, particularly of Japan after World War II and the East Asian NIEs, offered their views on the above-mentioned topics. They also pointed to possible lessons, both positive and negative, that the Japanese and East Asian experiences can provide for other developing economies in their endeavors to develop their economies. The panel concluded with a discussion of possible institutional and policy changes that the East Asian economies may need to undertake in order to become full-fledged economies within the next ten to twenty years.

II. East Asian Development: A Miracle or by Design?

The East Asian economies represent a diverse set of countries with different sets of initial conditions and different approaches to or strategies for industrialization and growth. Because of this diversity, some have suggested that the development experiences of these countries cannot be replicated by other developing economies. While it is true that each of the East Asian countries' development experiences has unique characteristics, it would be nevertheless erroneous to conclude that lessons cannot be learned. Indeed, in spite of the diversity, there are several common factors—both economic and noneconomic—that appear to have been critical to the economic success of these countries.

A. Economic Factors behind the Growth Process

The notable economic performances of the East Asian NIEs and Japan have several common elements. These include developed physical and social infrastructures, an export orientation of the economy, favorable external conditions, and macroeconomic stability.

A) Well-Developed Physical and Social Infrastructures

The development successes of the East Asian NIEs and Japan are characterized by the existence of well-developed physical and social infrastructures in these countries. Roadways, shipping lines, and communication facilities were relatively well-developed when these economies entered the industrialization stage of growth in the 1960s. To some extent, the small size of Taiwan, Hong Kong, and Singapore made provision of such physical infrastructure less difficult. But even for Korea and Japan, which are much larger in physical size, the physical infrastructure was not a constraint for industrialization and economic growth. There was relatively well-developed physical infrastructure in place when the process of industrialization began in these countries, but it increased further as a result ot the high rates of domestic investment in the subsequent period. During the 1960s, for example, investment-to-GDP ratios exceeded 10 percent in Korea and Singapore, and were about 20 percent in Hong Kong and Taiwan. In the 1970s, investment ratios jumped even higher and rose to as much as 40 percent in Singapore. A major ingredient behind these high investment rates is the ability of these countries to mobilize domestic savings. Indeed, the high savings rates of Japan and the Asian NIEs are well-known and have been contrasted with the disappointing savings performances of developing economies in other regions.

Equally important (some would argue perhaps more important) is the well-developed social infrastructure that prevailed in these countries. From very early on in their development, policymakers recognized that, lacking natural resources, their countries would have to develop on the basis of their domestic human resources. In developing their human resources, a strong cultural emphasis on education helped, but the governments also devoted significant efforts to establishing a good educational system, particularly at the primary educational levels, as early as the 1950s and 1960s. As a result, these countries entered the 1970s and 1980s with a better-educated and better-skilled work force than did many other developing nations in the world at that time. In addition to the high educational and skill levels of the labor force, these countries also had the advantage of having a relatively homogeneous population. Thus, the values and cultural norms among the individuals in the society were similar. This presence of an "Asian ethos" has often been referred to in other works analyzing the development success in East Asia.

B) Export-Oriented Growth

In Japan and the East Asian NIEs, the switch from import-substitution industrialization to export-oriented growth came about very early on. Given the limited size of their domestic markets, these countries became quickly aware of the limitation for growth involved with the imports-substitution strategy. Thus, while countries in Latin America continued to promote import substitution in the 1960s and 1970s, the NIEs that had initially followed this industrialization strategy had by then shifted its approach to one that emphasized development of the export industries. The results were dramatic. Growth of exports, industrial output, and gross domestic product were phenomenal. In the 1970s, for example, manufacturing output in the NIEs grew more than four times as fast as it did in Latin America and more than three times as fast as it did in Africa.

The impressive export and output growth performances continued in the 1980s and 1990s despite oil shocks and a worldwide slowdown in growth. The export orientation of these economies was an important factor for their ability to adapt to the adverse external conditions during that period. Not only did the export-oriented strategy encourage a more efficient allocation of resources as the countries participated in world trade, but over the longer term, the dynamic benefits including the exploitation of economies of scale in the larger export market, fuller utilization of existing capacities, exposure to more competition, and facilitation of transfers of technology and know-how allowed these countries to continue their robust growth in the face of less-than-favorable external conditions.

C) Favorable External Conditions in the Initial Stages of Industrial Development

Clearly, Japan and the Asian NIEs benefitted from a favorable environment in the world market in the 1960s and 1970s. For Japan, the golden decade of the 1960s in the world economy, and particulary the American economy, helped fuel its export expansion. For the East Asian NIEs a decade later, external conditions were also favorable as they embarked on their export drive. The appreciation of the U.S. dollar in the 1970s and of the Japanese yen in the 1980s especially helped create opportune conditions for NIEs' exports.

In the latter part of the 1980s and in recent years, however, the external environment has shifted. Sluggish economic growth and rising trade barriers in the developed countries suggest that other developing countries wishing to follow the NIEs' strategy of export orientation will find it difficult to achieve rapid growth with the same strategy. The trading environment that prevailed in past decades, which Japan and the NIEs were able to take advantage of so effectively, may no longer exist, and a new trading environment may require an alternative growth strategy.

While it is true that the trading environment may not be as conducive as it was, it is also true that the Asian NIEs have continued to perform well in terms of export and industrial growth during the 1980s and 1990s. The ability of these economies to adapt to changing market conditions and alter domestic policies accordingly has allowed them to maintain respectable, if not impressive, growth rates, despite the less-than-favorable external conditions.Thus, while world trading conditions proved to be beneficial to the NIEs' industrialization and growth drive, a more important factor would appear to be the flexibility within these economies to take full advantage of existing conditions. Thus, when conditions worsened, growth did not cease, but rather the countries responded by making the best of what it had and shifting resources to improve efficient allocation.

D) Macroeconomic Stability

Lastly, the general stability in the macroeconomic environment was another important element behind the continued high rates of growth in the Asian NIEs during the 1970s and 1980s. Unlike many Latin American countries, these economies did not suffer from excessive debt burdens or exceedingly high inflationary pressures. Ratios of external debt outstanding to GNP remained at 10 percent or less for the East Asian NIEs during the 1970s and 1980s. Even Korea, which is an exception with ratios of 20 to 30 percent during this period, did not find its debt burden a drag on its economy. Nevertheless, debt ratios for all of the Asian NIEs, including Korea, were significantly lower than those of the developing economies in Latin America and Africa. Chile once had a debt ratio as high as 63 percent and the Ivory Coast as high as 88 percent.

Moreover, inflation in the East Asian NIEs never reached the phenomenal heights that were witnessed in many of the Latin American countries in the 1970s and 1980s. Sound management of the economy's monetary and foreign exchange policies helped reduce wild fluctuations in the money supply and foreign exchange rates.

B. Beyond Economics

While neoclassical growth theory can explain some of the proximate causes behind the growth success of the Asian NIEs, a complete analysis of the development experiences of these economies must go beyond the conventional economic theories of growth. Indeed, it has been noted that in the neoclassical growth model, the conventional inputs of capital and labor can only explain about one-fourth of the growth that has occurred. Thus, the question arises as to what other ingredients can explain the high and sustained growth of these economies?

Further investigation into the common elements of the development experiences of Japan and the East Asian NIEs indicates that all of these countries faced a situation that led to the mobilization of a national consensus. Following the end of World War II, Japan was on the brink of starvation, and a national consensus emerged, focusing on economic growth and development. This involved a commitment, on the part of the people, private enterprises, and the government, to long hours and hard work and to the sacrifice of present consumption in exchange for economic growth. Most of the Japanese government's expenditures following the war were thus spent on industry-related or physical infrastructure projects; in addition, high import restrictions raised the prices of many consumer goods, but consumers were willing to suffer the high prices for the sake of Japan's industrial development.

A similar situation was faced in Taiwan and Korea in the early 1960s with their security concerns with mainland China and North Korea, respectively. Such a situation forged the emergence of a "developmental state," which has guided the private sector toward the goal of economic development. Hong Kong is probably a special case in this regard. Because, as a British colony, it had a well-developed infrastructure and political stability and because, with the takeover of China by the Communists, it became a haven for experienced entrepreneurs from mainland China with connections with overseas Chinese, Hong Kong had all the necessary ingredients for a free-market experiment and its success.

The key factor behind what some call a "situational imperative" faced by these economies is that they were able to develop a national consensus toward developmental objectives at not only the national but also at the social and individual levels. As a result, there was a common interest and willingness to forego consumption and leisure in their lifestyles.

History shows that other developing countries, including certain nations in Latin America and Africa, have also been faced with some kind of external threat similar to that experienced by Japan and most of the East Asian NIEs. The question thus arises: why did these countries in Latin America and Africa not follow the same development patterns as did Japan and the East Asian NIEs? In other words, why did these countries, which faced a similar challenge at one time or another, not respond to it the way that the Asian NIEs have done? It may be that if the challenge is too heavy, as was probably the case in Africa, there is, in fact, little positive response.

Whether an external challenge calls forth a positive response or overwhelms the country with a destructive result may depend on the "social capability" of the country that is threatened by the challenge. The concept of social capability has been used in describing the successful growth performances of Japan and other countries, although it has yet to be rigorously defined, and it is supposed to be determined in part by cultural and historical traditions as well as the ethnic and social structure of the population.

As was noted earlier, the relatively well-educated and skilled labor force, which was a crucial economic factor to these countries' phenomenal growth performances, was the result of a conscious effort on the part of the government, and with the eager support of the population, to institute a solid educational system. That is, the governments of these countries were willing to carry out an education policy and the citizens of these respective countries supported their government's efforts. This stands in stark contrast with the experiences of the developing economies in Latin America and Africa. To cite just one example, while Korea had 4,000 technicians and engineers in the early 1940s, Algeria had less than 20 in the early 1960s.

The explanation for these different experiences may lie in the fact that each of these East Asian economies is characterized by a homogeneous population and common cultural heritage. The "Asian ethos" referred to earlier, which stressed the importance of education, was pervasive not only at the state level but at the social level as well. This is not the case in Brazil, where the society is composed of many different ethnic groups; in this case, cultural tensions and distributional politics have tended to take up the attention of policymakers and influenced government expenditures such that development of the educational system was not considered to be a priority development goal.

III. The Role of Government in the Development Process

The East Asian experiences, with the exception of Hong Kong, present a case for an active role for government in economic development. Perhaps the most interesting finding from the East Asian experiences is a positive correlation between the stability of a political regime and a sustained growth rate. Along with its stability, the state in East Asia has also dominated society and thus had more autonomy and power to pursue developmental objectives than would be possible if the state was not so strong relative to society. In Taiwan, for example, the government implemented policies which encouraged direct foreign investment, directed credit towards targeted industries, and promoted savings. Similarly, the governments of Japan and Korea were directly and actively involved in many sectors in the economy, particularly the industrial sector as industrialization was viewed as the key to economic prosperity and attainment of a higher stage of development. This is not to say that the policies adopted and implemented by the governments were always successful and efficient. Taiwan's housing policy and some aspects of Korea's heavy-and-chemical industrialization (HCI) strategy are cases in point. Nevertheless, it is important to note that when these policies proved to be leading to inefficient or undesirable results, the governments were flexible enough to be able to shift their strategies.

Such flexibility was possible, in part, because of close, cooperative relationships between the government and large business. The close relationship between the government and the *chaebol* in Korea is well-known. Taiwan does not have an equivalent to the *chaebol* but it has many large state- or KMT-owned enterprises over which the government obviously has close control. Industrial associations, which play the role of an intermediary between the government and business, facilitate information flows and networking between the two and thus contribute to flexibility in policymaking.

In Korea and Taiwan, selective promotion of investment has been often carried out for the purpose of altering the industrial structure in anticipation of changes in demand and comparative advantage. To promote investment in selected areas, the governments have provided information to private entrepreneurs and socialized their business risk. In the case of Korea, the government was even directly involved in creating new industries with preferential credit and the licensing of foreign capital and technology flows. As these industries matured and became internationally competitive, however, they were provided with basically neutral incentives and preferential incentives were transferred to a new group of industries. In this way, the economies of Korea and Taiwan have been guided through successive stages of industrial development.

How such government intervention and close cooperative relations with business may have affected economic development in East Asia is still a controversial issue. Although such a role by government is conceptually inadmissible in the standard neoclassical economics, it is possible for such intervention to make a positive contribution to economic development once the government and large enterprises—both private and state-owned—in Korea and Taiwan are viewed as operating as if they together constitute an internal organization. Viewed in this way, direct government intervention is an internal transaction comparable to a transaction taking place within a private multidivisional corporation, and consequently, it can be efficient (or inefficient) for the same reasons that a private internal transaction can be.

IV. Lessons to Be Learned and Future Directions for East Asia

Rather than arguing that the development experiences of Japan and the Asian NIEs are unique and not replicable, this paper, which is based on a panel discussion at the First Seoul Journal of Economics International Symposium held on November 1993, argues that lessons can, in fact, be drawn from their successful experiences. They do suggest that for state intervention to make a positive contribution to economic development the state needs to have developmental objectives and a bureaucracy capable of formulating and implementing policies aimed at these objectives. The role of the state is, however, an evolving one, supporting and, in certain cases, leading the private sector in the early stages of economic development, but diminishing in importance as the economy develops and the private sector becomes more efficient in resource allocation.

There are basically three important lessons to be learned. For a developing country to develop it needs to (1) invest in physical and social infrastructure which will, in turn, improve the country's social capability, (2) adopt a strategy of export orientation and stable macroeconomic policies, and (3) establish a government that is committed to developmental goals and has an efficient bureaucracy. Such a government can accelerate the pace of development with a judicious industrial policy. It can promote certain sectors by working cooperatively with the private sector. Flexibility in policies is also important to prevent inefficient resource allocation for too long.

Before government can push forward specific industrial and development policies, it must first ensure that the general macroeconomic environment is stable. At the same time, attention must be paid to building the social capability of the society through investment in physical and social infrastructure and the human resources of the country. Increasing the social capability of the country will enhance the economy's ability to respond to external challenges. In terms of industrialization, the higher level of social capability will also facilitate direct foreign investment inflows, transfer of technology and know-how, and the competitiveness of the country.

In order to do all of these things, however, there must be a national consensus, a consensus both among the different branches and levels of government and between the government and the people. To be sure, the East Asian economies of Japan, Taiwan, Korea, and Hong Kong all had the advantage of a homogeneous population with a lengthy cultural tradition and similar values and ethos, as well as a long history of one-party rule (stable colonial rule in the case of Hong Kong).

In the current day, however, the situation in the East Asian countries has changed, and institutional changes may be needed in these economies to maintain their economic performances. That is, the same policies that worked well in the past may not necessarily work well in the future. As the conditions and the environment have changed, elements of the economic policies of these countries must reflect the new situation, with new elements being added and old ones deleted if necessary. Thus, appropriate policies would differ between developed and developing countries.

The industrial policies of the East Asian countries, for example, went beyond merely correcting for market failures in their early stages of development, and government intervention went so far as to promote targeted industries and directly channel resource and financial flows through credit and interest rate controls. While this may have been appropriate at that time, today, the situation has changed, and so must these countries' industrial strategy. Having achieved higher levels of development in the 1990s, the industrial policies of these countries should now be focusing on correction of market failures, where market failures can be defined to include new areas such as research and development investment. Unfortunately, the current regimes in these countries have maintained several elements of the "old" industrial policy which may no longer be relevant to the country's current stage of development.

In Japan, the consensus whereby society sacrificed current consumption for investment in future expansion of output has shifted and a new consensus has formed that stresses increasing personal welfare. Discontent among consumers against domestic producers who invest profits from improved technology rather than lower prices is growing. The rise in Japanese consumerism and demand for leisure time and activities are indications of this new consensus.

Thus, the experiences of the East Asian countries, while having unique characteristics, can guide other developing countries in terms of avoiding certain pitfalls and pointing to strengthening factors. At the same time, these countries which over the past three decades have had remarkable track records in terms of export growth, industrialization, and economic expansion are now also faced with the problem of finding an "appropriate" growth strategy to follow. There is no universal system that is best for all countries, and each of the East Asian countries will have to develop its own strategy of development based on its own cultural traditions, economic and political histories, and current weaknesses and strengths.