

Chapter 2

The Search of Strategic Management Capability: Lessons from the 'East Asian Miracle'

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The post-Cold War world is being shaken by two major forces: political democratization and economic liberalization. East Asia, now regarded as the world's growth center, has achieved rapid economic growth. This reality has sparked a new policy debate over whether development should be led by the government or the market, and specifically concerning the role of the 'guiding hand' and the 'invisible hand' in development management.

The neo-classical economic view of development aid, which emphasizes the market mechanism, has tended to prevail in this debate. Recently, however, there has been growing interest in the development mechanism (i.e., selective government intervention) that triggered the so-called 'East Asian Miracle'. East Asia's economic success stories show not only the importance of weighing the 'three failures' of economic policy management (i.e., the governments, the market, and the coordination of the two) in light of conditions in each country, but also the need to build strategic management capacity (i.e., adaptability, flexibility, and pragmatism) into each country's socio-economic system, as well as the potential to apply the East Asian approach in other regions.

This situation suggests that development economics may once again become an interesting facet of development studies. How can we go beyond the 'East Asian Miracle'?

This paper critically examines the lessons of East Asia from the viewpoint of development policies and highlights the importance of forming strategic development management capabilities by asking the following four questions.

First, what can we learn from the 'East Asian Miracle'? Second,

how can we form an institutional basis for shared growth? Third, are there any possibilities for applying the East Asian experiences to other developing regions? Fourth, what are the implications for new orientations in development aid policies?

1 The 'East Asian Miracle' as Intellectual Public Property

The history of development economics can be divided into a number of major trends, starting with the emergence of the discipline in the 1950s and 1960s. This initial phase was characterized by a structuralist approach that emphasized the role of government in economic development. The 'failure of government' triggered a schism into three schools of thought (i.e., the neo-classical approach, reformist approach, which included the basic needs approach, and the dependency, or neo-marxist, approach). The 1980s were the heyday of the neo-classical approach, which emphasizes the market mechanism.

In the 1990s, however, changes have started to emerge that may signal a second paradigm shift for development economics. Although this shift does not negate the prevailing trend toward the neo-classical approach, it is significant in the sense that it has led to the emergence of neo-institutional approaches (i.e., the transaction cost approach and the imperfect information approach), the new growth model approach (i.e., the endogenous development theory, the historical chance theory, the big push model), and the capability approach, in addition to the political economic approach to development. Also significant are the intellectual efforts that are being made to go beyond the neo-classical school.

This is leading to renewed recognition of the importance of long-term development strategies rather than just short-term crisis management, and of the role of government in an environment of uncertainty.

These shifts in development economics led to the implementation of an epochal study designed to discover the key to East Asia's economic development success. This project resulted from a positive initiative by the Japanese government (the Ministry of Finance), which has often tended to act as a 'sleeping partner' in the area of international development cooperation (especially with regard to policy dialogue and conditionalities in structural adjustment programs). The research was carried out by the World Bank, which follows a neo-classical approach. It took the form of a comparative study of eight economies: Japan, the 'Four Tigers' (Hong Kong, South Korea, Sin-

gapore and Taiwan), together with Indonesia, Malaysia and Thailand, which are classified as 'newly industrializing economies'. It was published as *The East Asian Miracle: Economic Growth and Public Policy* (the 'EAM Report'). What messages can be read from this study?

Since its publication in the autumn of 1993, the EAM Report has attracted considerable interest from officials and researchers in Japan and overseas. Today, not only neo-classical economists, but also structuralists and even interventionists are all rushing to cite East Asia's economic success as proof of the validity of their own theories about development strategy. It even seems that the East Asian Miracle has become a kind of 'intellectual public property' for the world of development studies, including economics.

Another key aspect of the EAM Report is its introduction of the concept of the 'functional approach' as a more refined version of the 'market-friendly approach', which the World Bank advocated in its *1991 World Development Report* in preference to the other two schools of thought on the government's role in economic development (the neo-classical school and the state development model). The World Bank's stance on policies 'getting fundamentals right' differs from the *laissez-faire* approach of leaving everything to market functions in the sense that, under certain circumstances, it tolerates selective intervention to ensure that the market principle can operate effectively.

However, another characteristic that must be kept in mind in order to understand the nature of the EAM Report is the fact that the World Bank does not go so far as to adopt a 'revisionist stance' and always seeks to justify this approach within a neo-classical framework. In particular, this is a typical expression of the limited value that the World Bank places on the benefits of 'industrial policy' (i.e., government intervention to modify resource distribution for the benefit of specific industries), including policy-based finance.

According to the World Bank's view, therefore, the East Asian Miracle can be interpreted as a process that has led to macroeconomic stability and the curbing of inflation, and to the attainment of the three growth functions (accumulation, distribution and productivity improvement) through the successful combination of selective intervention with policies relating to the establishment of fundamental conditions. As far as the importance of establishing fundamental conditions is concerned, there is wide support for the World Bank's view.

However, the results of a follow-up survey on the East Asian Miracle conducted by the OECF Research Institute of Development Assistance (RIDA) show, in light of subsequent debate in Japan and overseas, that the World Bank's position is contradicted by a wide range of views on the following four aspects.

First, there is the role of government in economic development and the response of the private sector (including the importance of political leadership, development diversity, social mobility, and social cohesion). Second, there is the effectiveness of industrial policy (including policy-based finance). Third, there are institutional aspects of economic development. And fourth, there is the replicability of the East Asian experience to other regions.

With regard to the policy debate over the role of government and the market in development management, it is particularly important to recognize that neither the free market approach nor the central bureaucratic control approach offer the sole formula for guaranteed growth.

To understand the real issue, it is perhaps necessary to consider what constitutes the optimal level of selective government intervention from the viewpoint of market development, taking into account various factors, including the underdeveloped state of markets in developing countries and the imperfection of information, and giving proper weight to not only to the two policy management failures (i.e., the failure of government and the failure of the market), but also to the failure of coordination between the government and the market. In this sense, the East Asian Miracle highlights not only the conventional grounds for government intervention (i.e., the failure of the market, justice in distribution, macro-economic stabilization), but also the need to foster market economies.

In the real world, the achievement of economic development depends not on a choice between a 'perfect market' and an 'imperfect government', or between an 'imperfect market' and a 'perfect government', but rather on efforts to discover the optimal combination by treading the narrow path between an 'imperfect market' and an 'imperfect government'. We need to remind ourselves of the importance of recognizing, through the valuable experience of the East Asian Miracle, that we can escape from the simplistic 'government versus market' dichotomy and discover a wider range of governance formats (including the effectiveness of developmentalist policy structures) for development management.

When considering whether the selective intervention approach,

which has been so successful in East Asia, can be applied in other regions, it is basically necessary to create practical development formulae by adopting country-specific approaches through studies that take account of a wide range of factors, including the development state and historical background of each country.

2 Forming an Institutional Basis for Shared Growth

Next, when undertaking a factor analysis of the East Asian Miracle, it is necessary to focus in particular on the institutional aspects of development. We would like to make the following five observations concerning the World Bank's EAM Report in relation to the institutional aspects of economic development.

First, the scope of the report's analysis of the institutional aspects of development is inadequate, since it focuses mainly on such aspects as the existence of technocrats, government-private sector harmonization through councils, and income redistribution mechanisms. This is a vital point for debate in the sense that the report fails to deal with the fundamental questions of why East Asian governments were able to achieve greater economic success than the governments of other developing countries through a process of trial and error and adaptation, and why these governments were able to build the ability to form and maintain interactive and effective relationships with the private sector through the efficient use of selective intervention and the flexible adjustment of the content and methods of intervention in response to changing internal and external environments.

Second, in connection with the preceding issue, there is the problem that the scope of the analysis in the World Bank report excludes 'institutions' that made an important contribution to economic development in East Asia. For example, the report does not take account of the fact that while East Asian countries have gradually formed basic legal systems and mechanisms (such as property rights and commercial law), which are vital to the efficient operation of a market economy, many developing economies have yet to establish these institutional frameworks. Other aspects excluded from consideration include the processes whereby the East Asian economies have gradually cultivated abilities and institutions that enable them to respond energetically and aggressively take advantage of opportunities created by technological innovation.

Third, the potential for the achievement of institutional reform is far greater than envisaged in the World Bank report. Instead of mere-

ly emphasizing the negative aspects of the existing level of institutional capacity as factors that limit the formulation and implementation of policies, the analysis should have placed greater emphasis on such questions as how institutional capacity can be enhanced such as through the reform of education or government agencies. One of the important lessons that we can learn from the East Asian experience is that it is by no means impossible to achieve the gradual development of capacity in one's own systems by learning from a variety of experiences, including the creation of various institutions. We need to ask first of all whether or not there is this basic perspective.

Fourth, also significant is the fact that many Asian experts stress the importance of a stable, strong political leadership committed to the national goal of rapid economic development. The common characteristics of political leadership in Asia are: (1) the positioning of economic development as the top priority for political management; and (2) a shared awareness among political institutions of the potential for and effectiveness of achieving long-term improvement in national living standards through the achievement of good economic performance, as a means of gaining recognition of an administration's legitimacy and further strengthening its power base.

Fifth, the economic development of Asian societies seems to have been influenced significantly in the following four areas by social factors, including social fluidity, social unity and the fairness of social structures, which characterize East Asian countries, and which have interacted within the processes of economic development.

(1) Development stimulated the emergence of the middle class and enabled more members of society to participate in the development process.

(2) Development had a limiting effect on social disruption triggered by tension and confrontation.

(3) Development reduced social demand for income redistribution and weakened the political pressure exerted by interest groups and vested interests on policy makers.

(4) Development fostered a social milieu in which people were willing to sacrifice the short-term interests of individuals in order to achieve long-term development goal, while helping to form a social environment in which it was easy to share an integrated national vision.

Aspects of the debate over the institutional aspects of the East Asian Miracle that relate to the institutional basis for shared growth are thus especially important. The World Bank report places considera-

ble importance on the commitment of East Asia governments to ensuring the rapid, widespread sharing of improvements in economic structures as a means of establishing a base for the legitimacy of development policies. The key mechanisms for this purpose are, as follows:

- (1) wealth distribution plans based on the concept of including non-elite groups in economic growth;
- (2) the existence of economic bureaucracies shielded from narrow political pressures; and
- (3) the existence of organizations and mechanisms that enable the government to share information with and gain the support of private sector elites.

In relation to specific approaches to the achievement of development goals, the World Bank report refers both to education and also development strategies designed to foster agriculture and small business, which form the foundations of society. In relation to agriculture, it ranks government agriculture support measures alongside land reform. As far as small business is concerned, the report recognizes that while growth is generally driven by market forces rather than government intervention, governments in some countries have supported small and medium enterprises by providing preferential finance and establishing special support services. To take this notion further, it would be reasonable to conclude that another characteristic of the East Asian Miracle is the fact that although governments have pursued export-oriented growth strategies, they have positively incorporated agriculture and small business into their development policies, instead of marginalizing sectors such as these.

The OECF's RIDA also conducted comparative studies relating to Thailand and South Korea in response to the issues raised in the World Bank report in relation to 'institutional basis for shared growth' as they pertain to agriculture and the small business sector. These studies show that the promotion of the small business sector has been emphasized during Thailand's economic development as a means of creating employment opportunities, ensuring the effective utilization of domestic resources, and alleviating regional imbalances. Other findings include the fact that agricultural finance has played an important role in agriculture, which is a key industry in Thailand. The studies also showed that the *saemaul* movement in South Korea contributed to the achievement of social cohesion, which is a prerequisite for growth, through such processes as the reduction of income gaps between the urban and rural sectors.

Numerous Japanese and foreign experts have offered comments on OECF surveys and research, including the aforementioned studies. For example, as observed by Professor P. Mosley of the University of Reading (then the University of Manchester), who is critical of the World Bank's structural adjustment policies, the World Bank report fails to recognize the role of government intervention in the alleviation of income gaps in East Asian countries (including the effectiveness of policy-based finance for small farmers and small and medium enterprises).

In relation to this issue, the OECF's RIDA also studied the effectiveness of policy-based directed credit as one of the measures for industrial policies. Their major findings can be summarized into the following five points.

First, from the viewpoint of the effectiveness of policy-based directed credit, since this tool is introduced to achieve future policy objectives, these objectives must be realised together with other policy measures that are implemented concurrently.

Second, policy-based directed credit must be introduced in such a way as to direct a country's financial market toward healthier development based on market principles (including the liberalization and internationalization of financial markets in the developing countries) and to contribute to the resulting effective allocation of resources (or at least not to disrupt effective resource allocation).

Third, from the viewpoint of the achievement of the policy objectives of policy-based directed credit, the adequacy and suitability of policies as the prerequisite of policy-based directed credit must be ensured.

Fourth, from the viewpoint of the relationship between policy-based directed credit and the development of the financial market as a whole, the existing financial markets in developing countries should be fostered, subject to such requirements as the prevention of capita flight and promotion of domestic savings, and against a backdrop of keener international competition for extremely speedy adjustment.

Fifth, from the viewpoint of the management of policy-based directed credit under market principles, the selection of end users and target projects for financing (or decisions about resource allocation through policy-based directed credit) should be free from arbitrariness and political influence, and should also be effected in line with the policy on which the policy credit is based, and in conformity with rules previously established on the basis of economic rationality (that is, fairness and neutrality). Only then can rent-seeking activities and

corruption be prevented. Indispensable for this purpose are assessment by intermediary financial institutions based on the characteristics of policy goals and final end users targeted by the policy, the establishment of a system to safeguard claims and support these efforts.

The OECF's RIDA reviewed in general terms the many conditions required for successful policy-based directed credit, as well as related problems in light of the OECF's experience. The conditions mentioned above are all closely related, and the extent to which they are satisfied varies with the country, sector and period.

Policy-based directed credit is applied at the interface of contact between macro- and micro-economies, between the financial sector and the policy-target sectors, between the government and the private sector, between efficiency and equity, between economic and social developments, and between monetary and fiscal policies. If the conditions for the efficient and effective management of a policy-based directed credit system are in place, the way will be paved for the applicability of the system to regions other than East Asia.

On the other hand, the importance of an 'institutional basis for shared growth' appears to have been verified to a considerable extent by Japan's own experience of economic development in the postwar period. It is important to recognize at least the following three aspects of the measures targeted toward agriculture and the small sector as part of the various reforms implemented in postwar reform.

First, rural land reform raised the motivation to produce by enabling farmers to own land. This encouraged farmers to save more, thereby contributing to the provision of funds for agricultural investment. The uptrend in farm incomes, which increased 1.8 times in the five years between 1960 and 1965, for example, helped to expand domestic markets, while rising productivity provided a source of labor for the industrial sector.

Second, while implementing economic democratization measures, including the dissolution of the *zaibatsu* (conglomerates), the avoidance of concentrations of economic power and the establishment of the Antimonopoly Law, the government also introduced systems to foster small and medium enterprises. Initially the government took a passive and protective stance in its small business policy, the aim of which was to protect small and medium enterprises as the weaker members of the business sector. From the late 1950s, onwards, however, technological progress was paralleled by a shift in emphasis toward the provision of support for facility modernization

and rationalization. As a result of this small business support policy, Japan began to move during the 1960s toward the elimination of its wage gap (dual structure) through the achievement of full employment and the emergence of a labor shortage. This played a key role in the expansion of domestic markets.

Third, financial assistance was a key element of support for agriculture and small business. In the agricultural sector, credit was provided through agricultural cooperatives and government financial institutions (such as the Central Bank for Agriculture and Forestry). The People's Finance Corporation (1949) and the Japan Finance Corporation for Small Business (1953) were established with government funding to assist small and medium enterprises. The fiscal loan and investment system functioned effectively in this context and played an important role.

In order to gain a clearer overall picture of the dynamic development process as a means of verifying the applicability of the East Asian experience to other regions, it will be necessary to examine, verify and enhance the methodology used in 'comparative studies of institutions'. The most important perspective in this context is to approach development as a dynamic process of transition through structural change from a traditional exchange economy to a modern market economy.

However, this work cannot be achieved solely through economic studies, since it also involves major issues relating to 'structural transformation' (i.e., social change) affecting society as a whole. 'Development issues' must be understood in terms of how flexible, competent and effective institutions can be created within the relevant social systems in order to allow these structural changes to occur.

If this view is correct, it is impossible to identify the dynamic processes of development without a comprehensive examination of the political, economic, social and cultural factors that make up the various institutions. In this sense, the most important tasks now are to create a 'system approach' that integrates the 'institutional approach' and the 'policy approach', and to conduct comparative study based on this approach.

We are thus seeking a new frontier in development studies, one that will take us beyond traditional economics and enable us to conduct comprehensive studies of the role of development policy in relation to government and the markets in developing countries. We see the East Asian Miracle as an 'knowledge treasure-house of information' that will revitalize development economics.

3 Replicability of the East Asian Experiences

Now, let us examine this discussion by considering how we will be able to go beyond the 'East Asian Miracle'.

It may be difficult to draw general lessons concerning development policy management because development policies and experience over the past forty years differ widely with the country and period. Nevertheless, it is important to point out, from a broader perspective, at least the following four practical lessons that can be gained from the past handling of development policy management.

First, in relation to development plans, the appropriate combination of the following three factors is a condition for promoting sustained economic growth: (1) stable macro-economic management; (2) market prices, including interest rates, centered on economic and industrial policies that fully utilize incentive systems; and (3) establishment of physical and institutional infrastructures and human resources.

Second, in relation to development models, it is necessary to select a combination of models appropriate to the economic and social systems and history of each country with differing levels and phases of development, including the coordination of comprehensive model approaches and micro-level model analysis.

Third, in relation to development assistance strategies (particularly structural adjustment programs), it is essential to ensure the effectiveness of policy dialogue and conditionalities by continuously assessing economic rationality and the political and social costs in the hope of continuously reforming policies. In addition, to ensure the adequacy of the policy package to respond to the actual circumstances of the countries concerned, adjustment programs which include institutional reforms should be integrated by stages as part of medium- to long-term development plans.

Fourth, in relation to the aid approach to development management, it is important that development management be considered not only from the viewpoint of administrative improvements through institutional and organizational development within the public sector but also from practical use of the market mechanism and managerial improvements in the private sector.

In addition to these four practical lessons, a more important lesson would be the need to form the 'strategic management capability' to make choices from diverse and complex options concerning development policies in the course of seeking organic cooperation between

the government and market in both areas of domestic and international systems.

The importance of this lesson is demonstrated by the experiences of countries that have developed successfully, including East Asian countries. The capability is twofold: the ability to learn from practice, and the ability to modify policies if necessary. Because of this capability, the system in question incorporates three elements: 'adaptability'; 'flexibility'; and 'pragmatism'.

In the world of development, the employment of proper policies is less important than the construction of economic and social systems that enable one people to recognize and adopt such policies at their own discretion. Without such internal efforts, a country cannot be expected to achieve development, and assistance from the aid-providing side is unlikely to yield the desired effect.

The early structuralists committed the error of regarding this capability of the economic and social systems as given. They assumed that the government already had the capability of managing its intervention. Considering the after-effects of unsuccessful intervention in the 1960s and 1970s, this assumption seems to have impaired confidence in their research achievements. These after-effects, however, have helped to revive neoclassicism, which has posed two problems.

First, despite many failures made by the government, public organizations are still expected to be directly involved in the improvement of social and physical infrastructure in developing countries. The market, which cannot alleviate poverty, does not supply the public goods on which the private market depends. The government plays a major role in this regard. What is more, strategic intervention is a prime mover for growth and development, as demonstrated by the experiences of East Asian countries.

Second, neo-classical theory does not adequately meet the needs of less-developed economies. As they admit, it seems that neo-classical economists are unable to give a convincing explanation of the process of development and its dynamic aspects. They suggest 'getting prices right' but fail to identify the necessary and sufficient conditions for appropriate prices. Such an approach would replace 'factual truth', which forms the ultimate end as well as the basis for explanation and prediction, with 'analytic truth'.

Awareness of these problems leads to the realization that it will be necessary to develop analytical models that can be used to explain how the development process can be controlled and managed. It also suggests the need to redefine 'development' from this viewpoint in

terms of whether development means 'growth', 'poverty reduction', or 'structural transformation'. A commonly observed characteristic in the process of the shift from a traditional exchange economy to a modern market economy is the 'structural transformation' of nations. The problems related to 'development' in this process should be viewed as problems of the creation of, or transformation into, flexible, useful and practically effective economic and social systems.

The problem of the 'replicability' of the experiences evidenced in the East Asian Miracle to other regions should be discussed not for the purpose of recommending the employment of similar policies, but for the purpose of learning practical methodologies for the development of the capabilities needed for dynamic economic and social systems that can adapt to a constantly changing world markets and seize opportunities.

The East Asian Miracle Report published by the World Bank in 1993 after enthusiastic studies of the lessons offered by the East Asian experience of development fails to show a sufficient and deep understanding of many institutional aspects. The major reason is the lack of distinction between 'policies' and 'institutions', in addition to a bias toward free market principles.

The World Development Report of 1997 entitled *The State in a Changing World* is under preparation. Taking into consideration the recent developments in development studies and policy discussions, the intellectual evolution of the World Bank is expected.

As we have examined in this paper, at the root of discussions about development management in the developing nations is the belief that development must be autonomous.

Lastly, we should like to emphasize that East Asian countries differ from other developing countries in that they have made effective and discretionary use of 'comprehensive economic cooperation' (i.e., aid, investment and trade) from Japan and other countries out of their longing for growth and equity, and that they have established many institutions and fostered the above-mentioned management capabilities through their own sustainable development efforts. Without such self-help efforts, assistance from any foreign country or international organization is unlikely to yield sufficient benefits. Without a firm will to develop itself, no country can be constructively helped in its efforts to develop the capabilities to realize its development.

The formation of 'strategic development management capability', which consists of the theory and practice that enable developing coun-

tries to implement reforms of their economic and social systems in order to achieve autonomous development, is a frontier that will require intellectual effort in terms of development assistance policies dealing with the interactions between development and assistance, and also in terms of new work in the fields of development studies, including development economics.

4 Some Implications for Development Aid Policies

At a minimum the East Asian development success calls for a reconsideration of development policies and of donor policies towards LDC's. The following four points might be suggested.

In the first instance, this experience supports the view that institutional capacity is a prerequisite for the sound economic policy making without which a country will never be able to develop. If correct policies are important in order to stimulate growth—which they are—then it is essential that institutions exist which are capable of choosing such policies. Where they do not exist they must be created. Imposing policies from outside is not only ineffectual or counter-productive (hence the importance of 'ownership' of reform programmes as now stressed by the multilaterals), it perpetuates precisely the institutional underdevelopment which led that economy to require reform in the first place. Without the internal capacity to make right choices, a country will never generate 'development'.

Hence, and secondly, this point of view does appear to offer a better explanation of the failure of some economies to respond to structural adjustment. It might also explain why many African economies—which by common agreement are most structurally underdeveloped—have failed to develop.

Third, the renewed emphasis on the importance of state-led strategy owes something to the increasingly more difficult external environment for developing countries now than heretofore. The relevance of the 'capability approach' is the importance it places not on a single set of 'correct policies', but on creating the capability within an economy to react flexibly, quickly and competently to specific individual challenges at the international level. In other words self sustaining growth requires the capability to meet the development challenges of changing external circumstances through decisive shifts in strategy and economic structure.

The importance of this emphasis lies in the constantly evolution of the external environment within which newly developing countries

must operate. Many observers doubt whether it is now feasible for newly developing countries to follow the development paths pioneered by East Asian states where lower world trade growth, more protective regional trade arrangements and greater protectionism exist. As a set of institutional pre-requisites and not just a particular set of policies, the lessons of East Asian development could be timeless and transferable.

Fourth, pressure on donor aid budgets and most importantly the decline in geopolitical significance of many developing countries, has cast attention on the appropriate balance between state, market and civil organisations within developing countries. This concern with institutional capacity has been reflected in 'good governance' criteria promulgated by the World Bank and, more comprehensively, in the 'political conditionality' rhetoric advanced by the US and the UK since 1990.

Behind such moves is the attempt to address issues such as how to organize the state to maximise its effectiveness, the strategies the state can use to maintain credibility in policy making and the regulatory limitations which civic society may impose on predatory behaviour by pressure groups and resource wastage.

These issues suggest the necessity of making improvements in development aid policy studies with special reference to the creation of 'socio-economic system' and the formation of 'strategic management capability'. The increasingly political nature of conditionality is also suggested in the processes of providing capital and technical assistance as well as in the new form of 'intellectual assistance'.

In the end, these issues we discussed in this paper will raise once again the question of how we might redefine 'development', for both the donors and the recipients in their political and economic acts of 'assistance'.

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