# Part I

# ISSUES OF STRUCTURAL ADJUSTMENT POLICIES

# 1

# Structural Adjustment as a Development Strategy

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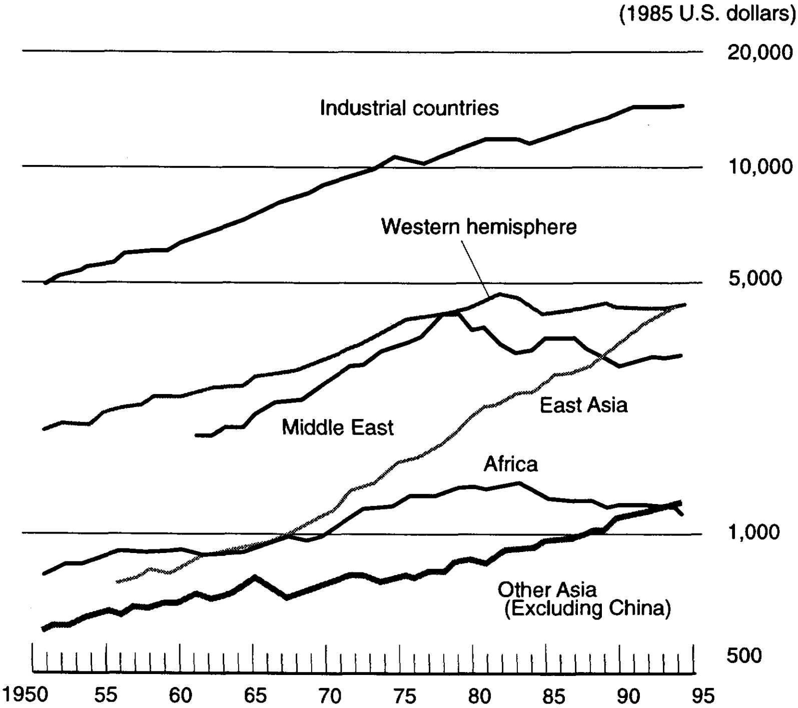
## 1. INTRODUCTION

According to the Penn World Tables, among the developing world only East Asia has attained steadily high per capita income growth throughout the entire past three decades (Figure 1). As a consequence, East Asia exceeded the Western Hemisphere with respect to income levels in the early 1990s, though it started from levels as low as Africa in the early 1960s. One may naturally call this a 'miracle.'

In recent years the quest for a desirable development strategy appears to have developed a new perspective. This perspective has been driven by both academic ideas such as the 'new growth theory' and policy concerns, as represented by the 'East Asian Miracle.' (World Bank [1993]) Structural adjustment, which we will discuss here, has much to do with these developments, since structural adjustment as a policy package has more or less reflected the above-mentioned developments in theoretical and policy-related thinking in terms of the degrees, paces and coverages of individual policy measures as they are put into practice.

On one hand, there has been a strong urge to explain the miraculous economic development of East Asia in comparison to other developing countries since the 1970s. East Asia was not exceptional in implementing structural adjustment after the second oil shock, as other developing countries, including those in Latin America. What ultimately differentiated the economic performance, particularly between East

**Figure 1** Postwar Real GDP Per Capita




Source: IMF, *World Capital Market*, May 1995.

Asia and Latin America? What was wrong with structural adjustment in Latin America?

On the other hand, since the 1980s we have observed nearly all the former centrally-planned economies shifting toward market economies, and they have become known as 'transition economies.' Economic reforms in these countries have been also undertaken along the lines of structural adjustment. Indeed, the issues which these transition economies are facing can be regarded as issues challenging economics as a policy science.

It seems that the policy advice given to transition economies has been based on multilateral agencies' experiences in a number of developing countries in Asia and Latin America. Many of them were suffering from serious economic troubles and heavy external debts, which themselves were regarded as the results of both external shocks and domestic mismanagement.

Developing economies suffered from the same and/or similar kinds of external shocks and domestic mismanagement during the 1980s. Most of these economies were hard hit by oil price hikes, declining primary commodity prices, higher international interest rates, and the slowdown of imports of the developed economies. Many policy authorities in these countries coped with the situation through external borrowing and enlarged budget deficits, resulting in heavy external debt overhangs and implicit or explicit domestic inflation. These economies were advised to take decisive measures toward short-run stabilization and long-run structural reforms, as conditionalities imposed on their borrowing from multilateral agencies.

The transition economies in Eastern Europe shared some features of the economic difficulties faced by those developing economies. Accordingly, there are reasons behind the application of policy prescriptions for developing economies to former centrally-planned economies. In fact, they share common objectives and means of economic reforms. They aim at both short-run economic stability and long-run development by controlling domestic inflation and opening up their economies to the rest of the world.

Recently, however, an increasing number of people have become more or less doubtful of the effectiveness of this type of policy advice. The doubt comes from two fronts. First, it has become a hot debate whether structural adjustment policy in practice is effective in the context of various developing economies. Second, it is no longer so clear whether this type of structural adjustment policy can be applied to these transition economies. In fact, recently, we have heard more and more arguments against the straightforward application of policy prescription designed for developing economies in general to former centrally-planned economies.[1]

The purpose of this chapter is to review the experiences of structural adjustment, to reassess its impact on developing countries and then to search for the major orientation for future research on the possible role of structural adjustment. In the following we analyze two main episodes in the experiences of structural adjustment. One is the external debt problem since the 1980s, and the other the transition of former centrally-planned economies to market economies since the 1990s. These episodes remind us of their deep roots at the very base of development strategies.

In Section 2, we examine the close relationship between external shocks and economic structures, briefly review the experiences of structural adjustment, and then suggest a possible trade-off between stabilization and structural reforms. Then in Section 3, we point out some difficulties inherent to transition economies, briefly analyze the underlying structural causes of these difficulties, and then suggest possible hidden factors that may give new insight for future development strategies. Finally, Section 4 overviews East Asian development experiences and then we conclude the chapter.

## 2. STRUCTURAL ADJUSTMENT FOR DEBT PROBLEMS

In the 1970s many middle income developing countries attained comparatively high economic growth through increased capital inflow, mainly in the form of loans. In this process the interrelationship between these countries and the international economic environment became closer through trade and capital flows. While this enabled higher economic growth free from the constraints of domestic market and/or domestic savings, this increased openness required that economic policy be more rationalized and flexible.

Macroeconomic performance in these countries became more and more diversified in the 1980s. The 'debt crisis' of developing countries was both the result and the cause of this. The crisis is the result because continuous macroeconomic imbalances supported by external borrowings led to debt accumulation, but it is the cause because the abrupt drying up of capital inflows due to the debt crisis compelled deflationary measures which brought about disastrous macroeconomic consequences.

Accordingly it is useless to compare the macroeconomic performance of problem debtors to other borrowers following the debt crisis. Instead, more interesting is what magnified the imbalance in the process toward 'problem debtors' before the debt crisis, and particularly, which of the factors as external shocks, short-run stabilization policies and long-run structural impediments were most important in making countries into problem debtors.

Adjustment policies for developing countries in the 1980s have often been discussed in terms of comparisons between the success of East Asia and the failure of Latin America.[2] However, the Philippines in East Asia and Chile in Latin America are well known to be exceptions to such generalizations. As a matter of fact, macroeconomic performance has been diverse even among East Asian countries. We will try to clarify how the magnitudes of external shocks and macroeconomic adjustments to cope with them in the early 1980s affected their macroeconomic performances and the time paths of their external debt accumulation.

## 2.1 External Shocks and Economic Structures

The three non-oil East Asian countries achieved relatively rapid growth in the 1970s with ambitious investment beyond their domestic savings, by financing this gap mainly with foreign loans from private as well as official sources. A series of 'external shocks,' however, revealed that these growth-cum-debt strategies had been supported by a set of favorable conditions and that this fact had never been fully recognized.

Since the end of the 1970s these external events, which were outside the control of developing countries, shocked the international economy. These included higher international interest rates, the second oil price hike, a recession in developed economies, and collapsing primary commodities prices. First, because of the higher interest rates, economies with larger variable interest rate debts and short term debts suffered from an abrupt increase in interest payments for an extended period. Second, both the oil price hike and the commodity price drop deteriorated the terms of trade of oil importing and/or primary commodity exporting economies. In addition, the recession in the developed economies in the early 1980s prolonged for several years, resulting in not only a fall in primary commodities prices but also persistent stagnation in world imports, which reduced the export income of developing economies.

Thus the external shocks had negative impacts on a broad range of developing countries. Not all, however, became 'problem debtors.' Does this imply that some, and in particular these problem debtors, suffered more seriously from the shocks than the others?

It is not difficult to see that the impact of external shocks depends on economic structures, and is thereby diverse across economies. On one hand, changes in the terms of trade are determined by the movements of relative prices among tradables and the trade structure, as shown in Table 1. The former is dominated by the prices of oil and other primary commodities, which are more volatile than those of other goods. Accordingly, the terms of trade for oil and primary commodities exporters varies in a totally opposite direction from those of non-oil manufacturing exporters.

On the other hand, changes in the real interest rate depend on relative movements between nominal interest rates and price deflators. For the former, the effect of higher international lending rates on nominal borrowing costs is determined by the debt structure, including the relative shares of concessionary debt, variable interest debt and short-term debt. Naturally, the larger the share of concessionary debt and the smaller the share of variable and short-term debt, the smaller the impact on the nominal borrowing cost would be.

**Table 1** Trade Structure: East Asia, 1980–86

(% share)

| | Exports | | | | Imports | | | |
|---|---|---|---|---|---|---|---|---|
| | Primary commodities | | Manufacturing | | Primary commodities | | Manufacturing | |
| | 1980 | 1986 | 1980 | 1986 | 1980 | 1986 | 1980 | 1986 |
| Indonesia | 96.0 | 79.6 | 3.9 | 20.2 | 33.1 | 24.2 | 66.7 | 75.4 |
| | (74.3) | (56.1) | | | | | | |
| Korea | 9.5 | 7.4 | 90.2 | 92.6 | 55.1 | 33.4 | 44.6 | 67.7 |
| | | | | | (29.9) | (14.7) | | |
| Philippines | 60.3 | 34.0 | 23.5 | 36.3 | 40.1 | 31.3 | 48.9 | 46.9 |
| | | | | | (28.4) | (18.5) | | |
| Thailand | 60.1 | 53.9 | 34.9 | 44.9 | 41.5 | 26.4 | 55.4 | 71.4 |
| | | | | | (31.1) | (13.4) | | |

Note: Share in total exports or imports. Primary commodities denotes items 1 through 5 of SITC classification and manufacturing items 6 through 8. Parenthesized are item 4 of oil related goods.

Source: Calculated from ADB, *Key Indicators of Developing Member Countries of ADB*, July 1988.

**Table 2** Debt Structure: East Asia, 1977–82

(% share)

| | Concessionary debt | | Variable interest rate debt | | Short-term debt | |
|---|---|---|---|---|---|---|
| | 1977–79 | 80–82 | 77–79 | 80–82 | 77–79 | 80–82 |
| Indonesia | 52.4 | 47.4 | 16.2 | 18.0 | 11.0 | 15.3 |
| Korea | 22.6 | 16.6 | 24.6 | 33.8 | 29.7 | 34.1 |
| Philippines | 20.0 | 17.7 | 23.0 | 32.0 | 37.4 | 47.2 |
| Thailand | 29.1 | 23.6 | 17.9 | 30.7 | 39.5 | 27.9 |

Note: Shares in the total long term public and publicly guaranteed debt for "concessionary and variable interet rate debts" and the ratio to the total long term public and publicly guaranteed debt for "short term debt."

Source: Calculated from World Bank, *World Debt Tables*, various issues.

Table 2 summarizes external debt structures across the two periods, i.e. before the external shocks and before the debt crisis. We are concerned here with the first one. The Table suggests that, among the three, the impact of higher international interest rates must have been greatest on the Philippines, followed by Korea, then by Thailand.

Changes in the terms of trade and the real interest rate and the welfare factor changes or the shocks caused by unfavorable changes in these are summarized in Table 3. Unfavorable changes in terms of trade were found in 1979-81 for Korea, with the shock amounting to 5% of GDP in

**Table 3** Estimation of External Shocks: East Asia, 1979–87

| | Terms of trade (TOT) | Real interest rate (RIR) | TOT shock | RIR shock | Total |
|---|---|---|---|---|---|
| | (% change) | | (% of GDP) | | |
| Korea | | | | | |
| 1979 | –2.1 | 3.3 | –0.8 | –1.1 | –1.9 |
| 1980 | –13.3 | 4.5 | –5.0 | –1.6 | –6.6 |
| 1981 | –2.1 | 8.6 | –0.9 | –4.0 | –4.9 |
| 1982 | 4.3 | 2.4 | 2.0 | –1.1 | –0.9 |
| 1983 | 0.9 | –2.6 | 0.4 | 1.3 | 1.7 |
| 1984 | 2.2 | 0.6 | 0.9 | –0.3 | 0.6 |
| 1985 | 0.5 | –3.2 | 0.2 | 1.5 | 1.7 |
| 1986 | 8.9 | –2.6 | 3.5 | 1.4 | 4.9 |
| 1987 | 2.4 | –5.9 | 1.0 | 2.7 | 3.7 |
| Philippines | | | | | |
| 1979 | 4.5 | 1.6 | 1.2 | –0.7 | 0.5 |
| 1980 | –16.0 | 5.7 | –4.4 | –2.4 | –6.8 |
| 1981 | –12.0 | 15.5 | –3.5 | –7.3 | -10.8 |
| 1982 | –2.8 | –1.9 | –0.8 | 1.0 | 0.1 |
| 1983 | 4.4 | –6.5 | 1.3 | 3.8 | 5.1 |
| 1984 | –2.4 | –1.2 | –0.8 | 0.8 | 0.0 |
| 1985 | –6.7 | 3.4 | –2.0 | –2.4 | –4.4 |
| 1986 | 7.4 | –0.0 | 1.9 | 0.0 | 1.9 |
| 1987 | 9.0 | –6.8 | 2.4 | 6.2 | 8.5 |
| Thailand | | | | | |
| 1979 | 3.3 | –3.8 | 0.9 | 0.8 | 1.7 |
| 1980 | –4.7 | 4.3 | –1.5 | –1.0 | –2.5 |
| 1981 | –12.9 | 12.2 | –4.2 | –2.9 | –7.1 |
| 1982 | –9.3 | 3.5 | –3.1 | –1.0 | –4.1 |
| 1983 | 7.5 | –1.4 | 2.2 | 0.4 | 2.6 |
| 1984 | –1.7 | 0.1 | –0.5 | –0.0 | –0.6 |
| 1985 | –6.3 | –3.6 | –1.9 | 1.2 | –0.7 |
| 1986 | 10.7 | –4.5 | 3.3 | 2.0 | 5.3 |

Source: Kohsaka (1991).

1980. The terms of trade shock affected the Philippines and Thailand in 1980-82, with roughly the same magnitude, i.e. 3 to 5% of GDP. The lag of the shock between Korea and the other two was again due to their different trade structures.

The real interest rate shock was diverse in magnitude and timing across the countries because it depends not only on nominal interest rates but also on export price movements, as suggested above. The total welfare loss resulting from the external shocks amounted to at least 5% of domestic production in all three countries. More importantly, distinctive differences in magnitude of the shocks could not be found between the countries. This leads us to be negative toward the hypothesis that differential magnitudes of external shocks generated different macroeconomic performances. Thus, in the next section we will turn to a domestic factor, specifically the role of macroeconomic management in the adjustment process.

## 2.2 Macroeconomic Management under External Debt

The debt crisis can be regarded not only as its cause, in the sense that abruptly severed capital inflow forced harsh adjustment measures, but also as its result, in that domestic mismanagement led to lost confidence, and thereby to the crisis, as we will see below.

Here we need to remember that a dramatic change in capital inflow to developing economies occurred not immediately following the external shocks, but only after the debt crisis began in 1982. As a matter of fact, the pattern of global capital flows to developing economies remained unchanged during the period of 1979-82 as it had been in the late 1970s. Responses of policy authorities to the external shocks were far from identical, though. Some shifted to swift tightening, but some kept expanding. How should they have reacted to these shocks in terms of stabilization policies?

Let us here compare the performance of stabilization measures taken by Asian and Latin American countries during the adjustment years of 1979-82. The investment ratio fell in Asia, but did not in Latin America. The budget deficits of central governments expanded more in Latin America than in Asia, which led to explosive domestic inflation. Domestic price stability is indispensable to maintaining a stable real exchange rate, which contributes to the development of export sectors. In addition, real appreciation arouses expectations for devaluation, thereby alluring de-stabilizing capital outflow. Consequently, current account deficits as a ratio to GDP rose in Latin America as opposed to Asia, where they remained almost the same.

Apart from these short-term adjustment measures, long-term structural policies for fiscal balance, monetary control, investment and external trade can play a significant role in moderating the degrees of external shocks and necessary short-term adjustments. For instance, if the fiscal structure is flexible and financial markets are well developed, fiscal deficits would not directly result in domestic inflation. While these structural reforms can enhance macroeconomic stability in general, structural reforms of export sectors would be indispensable for directly improving the solvency for external debt, as it is suggested that the degree of external shocks depends on trade structures. The real problem is, however, that once a country is trapped with 'debt overhang,' it may become extremely difficult to pursue structural adjustment.

### 2.3 Structural Adjustment under Debt Overhang

The international debt strategy such as the Baker Plan turned out to be unsuccessful. Part of the reason was the unexpected development of international economies on one hand and incomplete understanding of macroeconomic adjustment mechanisms in countries under debt overhang on the other.

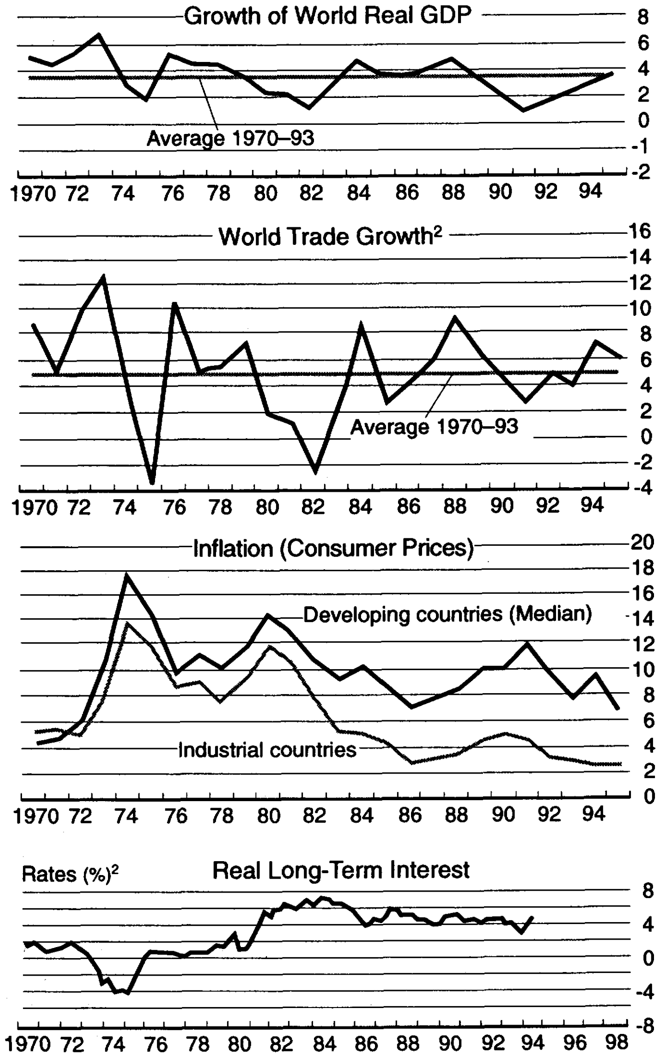
Simple 'debt dynamics' tells us that, as long as the nominal export growth rate plus the (non-interest) current account deficit/debt ratio exceeds the nominal loan interest rate, the debt/export ratio will not explode. Indeed, this sustainability condition was sufficiently met during the latter half of the 1970s. This did not, however, hold true for the 1980s (See Figure 2). Interest rates fell slowly, but remained relatively high. Recovery in industrial countries and in world imports was so slow that primary commodity prices declined sharply and export volumes were stagnant. Accordingly, although debtors generated significant surpluses in their non-interest current accounts, their export/debt ratios kept on increasing until 1987.

What went wrong was not, however, just due to mis-forecasts. The debt strategy had perceived the problem as a liquidity shortage and had paid little attention to how to enhance solvency through economic growth. The real problems lie here.

Structural adjustment programs consist of short-run macroeconomic stabilization and longer-run microeconomic structural reforms. Countries under debt overhang had to conduct these programs with virtually no net capital inflow, because private commercial banks *rationally* ran away on the same wagon. The debtors had no choice but to place their first priority on generating current account surpluses, and emergency measures such as import restrictions were maintained for long periods. Imports of Latin America fell sharply and remained at only 80 percent of their 1981 levels even in 1989. This import cut led to lower investment through reduced imported capital and intermediate goods, hampered economic growth, and expanded fiscal deficits. In other words, the structural adjustment triggered a vicious circle of events.

In fact, the macroeconomic performances of countries in Asia and Latin America during the adjustment process following the debt crisis

**Figure 2** International Economic Environment, 1970–93




Notes: 1. Including IMF staff projections.

2. Ten-year government bond yields (or nearest maturity) for the major industrial countries. The real interest rate is defined as the average of the nominal interest rates minus the four-quarter percentage change in each country's GDP deflator.

Source: IMF, *World Capital Market*, May 1995.

**Table 4** Investment/GDP Ratio, 1950–89

(%)

| | 1950–59 | 1960–69 | 1970–79 | 1980–89 |
|---|---|---|---|---|
| Industrial countries | 24.5 | 27.8 | 28.3 | 26.2 |
| North America | 24 8 | 24.8 | 24.1 | 23.6 |
| Western Europe | 24.1 | 29.4 | 28.9 | 25.2 |
| Japan | 21.6 | 36.1 | 39.9 | 35.9 |
| Developing countries | — | 20.3 | 24.9 | 23.5[1] |
| Africa | — | 12.5 | 17.2 | 14.6 |
| Asia | | | | |
| East | — | 14.2 | 23.0 | 27.2 |
| Others[2] | — | 15.3 | 16.9 | 17.1 |
| Middle East | — | 12.6 | 16.3 | 20.6 |
| Western hemisphere | 17.7 | 17.5 | 20.8 | 17.2 |

Notes: 1. 1980–87
2. Excluding China.
Source: IMF, *World Capital Market*, May 1995.

stand in stark contrast. In Latin America, economic growth fell to barely 2 percent and investment/GDP to less than 20 percent in the 1980s (See Table 4). In Asia, investment/GDP hardly declined at all, and it is well known that they enjoyed far more than moderate economic growth.

## 2.4 Macroeconomic Stabilization vs. Microeconomic Reforms

The debt overhang might not be the whole explanation for why the policy recommendations for structural adjustment do not always appear to have been successful. First, the implementation of these recommendations was hampered by the decision-making processes of the different countries. Second, the accompanying programs were under the strong sway of a simplistic market-oriented view. As noted earlier, structural adjustment programs require microeconomic liberalization as well as macroeconomic stabilization. It is, of course, a fact that serious price distortions and inflexible fiscal budgets have existed as a result of excessive government intervention such as subsidies, price-support programs, and protectionistic trade policies. Without doubt, significant reductions of government intervention would be not only necessary, but even correct.

Nevertheless, it is not easy to determine how fast, in what order, and to what extent deregulations in various fields/sectors markets should be implemented. Furthermore, structural adjustment measures may sometimes conflict with short-run stabilization. If these long-term structural reforms such as trade liberalization and financial deregulation constitute the main part of conditionalities, it is likely that pre-committed liberalization measures will endanger economic stabilization efforts.

More recently, it has become better understood that the market system does not stand on its own, but can be built on a variety of visible and invisible infrastructures, which include private property rights as well as judicial and accounting rules governing economic activities. More important, we must stress, is macroeconomic stability. Macroeconomic stability and sustained growth are the proof of government authorities' ability to manage, help establish the confidence of market participants in the system, and in turn constitute the very basics to the working of the market.

What has brought about the success of adjustment in East Asia and its failure in Latin America in the 1980s? At least a part of the answer would lie not in liberalization, but in macroeconomic stabilization in East Asia. In fact, liberalization policies in East Asia appeared to have been deliberately conducted in very selective and gradual ways, especially in contrast to Latin America. This suggests that, during the process of structural adjustment, we ought to be more flexible so that liberalization measures do not devastate macroeconomic stability.

The 'growth-cum-debt' policy requires that developing countries' policy authorities carry out flexible and decisive macroeconomic management in response to the sometimes volatile international economic environment. On one hand, as indicated earlier, international capital flows move in parallel with the development of domestic capital markets. On the other, they can be either kind or unkind in the sense that they magnify successes and failures in domestic policy management. This contrast is impressively demonstrated by selected macroeconomic indicators for high-inflow countries in Asia and Latin America in Table 5.

The Table clearly shows the contrasts in these two groups of countries before and after the debt crisis in 1982, although both were successful in tapping international capital flows in the early 1990s. In 1977-82, before the crisis, the Asian group increased private saving and external trade with moderate domestic inflation, stable real exchange rates, and modest current account deficits, whereas the Latin American increased private consumption with higher domestic inflation and real exchange rate appreciation.

For the adjustment period of 1983-89, the Asian group kept on increasing domestic saving and external trade with still moderate inflation and real exchange rate depreciation. The Latin American group was forced by negative capital inflow to cut current account deficits, which resulted in lower domestic investment, higher inflation, and lower economic growth. The situation has not changed very much even in the 1990s, as the Table shows, even though the Latin American group has seen a slight improvement in terms of budget deficits and capital inflow.

**Table 5** Macroeconomic Indicators: Selected Asia and Latin America, 1973–93

| | 1973–76 | 1977–82 | 1983–89 | 1990–93 |
|---|---|---|---|---|
| **Asia** | | | | |
| High inflows (1990-93)[3] | | | | |
| Real GDP[1] | 4.7 | 6.2 | 7.9 | 7.5 |
| Consumer prices[1] | 8.8 | 7.7 | 7.5 | 7.4 |
| Private investment | 27.3 | 27.9 | 31.4 | 33.5 |
| Private consumption | 73.8 | 73.6 | 69.1 | 66.4 |
| Exports | 12.7 | 15.2 | 16.6 | 21.8 |
| Imports | 13.3 | 16.2 | 18.1 | 22.9 |
| Current account balance | –0.3 | –1.2 | –0.9 | –1.2 |
| Fiscal deficit | –1.1 | –3.0 | –3.1 | –2.2 |
| Debt | 12.1 | 15.8 | 24.1 | 26.8 |
| Debt service | 9.0 | 11.7 | 17.0 | 12.8 |
| Real effective exchange rate[1,2] | — | 0.7 | –6.3 | –6.8 |
| Total net capital inflow | 1.6 | 2.1 | 1.8 | 3.6 |
| **Western hemisphere** | | | | |
| High inflows (1990-93)[3] | | | | |
| Real GDP[1] | 6.2 | 4.3 | 2.4 | 2.1 |
| Consumer prices[1] | 30.0 | 43.6 | 143.7 | 250.3 |
| Private investment | 22.7 | 23.5 | 20.0 | 20.5 |
| Private consumption | 73.1 | 77.5 | 76.2 | 78.8 |
| Exports | 9.3 | 10.4 | 14.7 | 12.1 |
| Imports | 9.9 | 10.9 | 10.3 | 11.2 |
| Current account balance | –3.0 | –4.6 | –0.6 | –2.0 |
| Fiscal deficit | –2.4 | –4.3 | –5.3 | –0.1 |
| Debt | 19.9 | 31.8 | 50.2 | 35.4 |
| Debt service | 30.5 | 47.9 | 42.5 | 30.9 |
| Real effective exchange rate[1,2] | — | 3.2 | –2.2 | 2.2 |
| Total net capital inflow | 4.0 | 4.2 | –2.4 | 2.9 |

Notes: 1. Annual percent change. Figures for 1973–76 correspond to 1974–76.
2. Date for real effective exchange rates are available only from 1979 onward. The data reported for the period 1977–82 are for the period 1980–82.
3. In defining the high- and low-inflow groups, countries within each region were ranked on the basis of the average net capital inflow during the period 1990–93. Small countries with purchasing-power-parity (PPP) shares less than 0.1 percent in each region were excluded.

Source: IMF, *World Capital Market*, May 1995.

And this is the basic background where the Mexican crisis erupted toward the end of 1994.

## 3. STRUCTURAL ADJUSTMENT DURING MARKET TRANSITION

The policy advice given to 'transition economies' had been based on multilateral agencies' experiences in many developing countries. They have been advised to take decisive measures toward short-run stabilization and long-run structural reform. There are reasons, no doubt, behind the application of policy prescriptions for developing economies to former centrally-planned economies. Recently, however, increasing numbers of people have become doubtful of the effectiveness of this type of policy advice.

First, because these economies were under the Commission of Mutual Economic Assistance (CMEA) regime, the degree and timing of the external shocks were fairly different on the former CMEA and other developing economies. In particular, the collapse of the CMEA regime gave a deep blow to the member economies.

The CMEA regime was a system of intra-regional trade based on price distortions. Once the system collapsed, the member economies were exposed to international trade with competitive prices which were totally different from those distorted prices. In addition, the CMEA regime was a system of regional integration. Once it collapsed, it was found that the whole structure of production based on distorted prices would have to be reshuffled.

Second, and no less importantly, the former CMEA economies had to confront the collapse of their entire economic system. They found that their economic reform would require not just partial revisions, but revolutionary changes in total institutional arrangements. The reform was to introduce a new ownership system based on private property rights, a new corporate system through privatization, a new banking system to replace the mono-bank system, and a new fiscal and social security system.

Of course, in capitalist developing economies we have often observed, for instance, soft budget constraints between governments and state enterprises, and 'financial repression' in regulated banking systems. But at least we could say that those economies were based on private property rights and decentralized decision making. The difference between the 'capitalist' developing economies and the former socialist economies is not a matter of degree. We must realize, thus, that there is 'a sea of difference' between the start and the goal of economic reforms in the case of the former socialist economies, which require far more comprehensive reforms than do other developing economies.

Another recent development and/or turmoil in policy thinking concerning transition economies is over how to evaluate or reconcile contrasting economic performances in Eastern Europe and the former Soviet Union on one hand, and in China and Vietnam on the other (See McKinnon [1994] and Sachs and Woo [1994], for example). The present discussion will look toward the method of reform management, and the initial conditions of the reform. Before doing so, we will clarify the mechanism inherent to transition economies which creates a variety of economic responses in the process.

### 3.1 Transition Process: Adjustment vs. Reform

The typical problems faced at the start of economic reforms are domestic inflation, fiscal deficits and external imbalances under pervasive price distortions and financial repression. The prescription for stabilization should thus be fiscal restraint or reduced subsidies, domestic price liberalization, foreign exchange rate devaluation and monetary restraint. In Eastern Europe and the former Soviet Union, the result has been a disastrous combination of unexpected price inflation and output decline despite transitory improvements in external balances. (Table 6)

*Stagflationary impact*

The extent of price explosions caused by price liberalization has been harsh, sometimes far beyond initial expectations, and this inflation has not subsided swiftly in Eastern Europe and Vietnam. In China where price liberalization was undertaken at a slower pace, inflation was fairly high as much as 20 percent, but not so much accelerated as in the others.

To cope with this type of hyper-inflation, one can say that the larger the once-and-for-all price shocks, the shorter the duration of its impact. We must note also, though, that industrial adjustments take time, so that price liberalization does not necessarily guarantee quick improvements in resource allocation but may even hamper it by increasing risks. Sectoral imbalances and the resulting inflation may thus last for some time.

Output response to the new incentive system, namely liberalized prices has sometimes been greater than expected.[3] Among other things, output drops have been sharp and their duration has been unduly long in Eastern Europe and the former Soviet Union. In particular, the response of the *ancien régime* structure of production, namely the state enterprises, has generally been slow and their output declines pervasive. On the contrary, output decline in Vietnam was relatively short-lived, and there was only transitory stagnation, but non-negative output growth in China.

**Table 6** Output Growth and Consumer Inflation: Transition Economies, 1990–94

| | Real GDP | | | | | Consumer prices | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1990 | 1991 | 1992 | 1993 | 1994 |
| Countries in transition | −3.5 | −11.8 | −15.5 | −9.0 | −8.3 | 32 | 98 | 731 | 688 | 331 |
| Central and Eastern Europe | — | −11.5 | −11.7 | −5.7 | −5.4 | — | 103 | 370 | 442 | 217 |
| Excluding Belarus and Ukraine | — | −12.6 | −9.9 | −2.3 | 1.4 | — | 110 | 185 | 138 | 88 |
| Albania | −10.0 | −27.7 | −9.7 | 11.0 | 8.0 | — | 36 | 226 | 85 | 27 |
| Belarus | — | −1.2 | −9.6 | −11.6 | −17.1 | — | 84 | 969 | 1,188 | 1,621 |
| Bulgaria | −9.1 | −11.7 | −5.7 | −4.2 | −2.0 | 24 | 334 | 82 | 73 | 81 |
| Croatia | — | — | — | −3.2 | 1.8 | — | — | — | 1,516 | 98 |
| Czech Republic | — | — | — | −0.3 | 1.5 | — | — | — | 21 | 9 |
| Former Czechoslovakia | −0.4 | −15.9 | −8.5 | — | — | 11 | 59 | 11 | — | — |
| Estonia | — | −11.3 | −17.0 | −2.1 | 6.0 | — | 211 | 1,069 | 89 | 47 |
| Hungary | −3.5 | −9.9 | −5.1 | −2.0 | 1.0 | 29 | 34 | 23 | 22 | 19 |
| Latvia | — | −8.3 | −33.8 | −11.7 | 4.1 | — | 124 | 951 | 109 | 36 |
| Lithuania | — | −13.1 | −37.7 | −16.5 | 4.7 | — | 225 | 1,020 | 410 | 69 |
| Macedonia, Former Yugoslav Rep. of | — | — | — | −15.5 | −14.7 | — | — | — | 248 | 65 |
| Moldova | — | −18.1 | −20.6 | −14.8 | −2.2 | — | 162 | 1,276 | 688 | 245 |
| Poland | −11.6 | −7.6 | 2.6 | 3.8 | 4.5 | 586 | 70 | 43 | 35 | 30 |
| Romania | −7.4 | −15.1 | −13.5 | — | — | 5 | 161 | 210 | 256 | 156 |
| Slovak Republic | — | — | — | −4.1 | — | — | — | — | 23 | 14 |
| Slovenia | — | — | — | 1.0 | 4.0 | — | — | — | 32 | 18 |
| Ukraine | — | −11.9 | −17.0 | −14.2 | −25.0 | — | 91 | 1,210 | 4,735 | 1,000 |
| Former Yugoslavia | −7.5 | −17.0 | −34.0 | — | — | 583 | 117 | 6,147 | — | — |
| Russia | — | −13.0 | −19.0 | −12.0 | −12.0 | — | 93 | 1,353 | 915 | 336 |

Note: Data for 1994 are IMF staff projections.
Source: IMF, *World Capital Market*, May 1995.

*Transmission mechanism*

This 'output collapse' during reform, which has generated explicit and implicit unemployment and helped reduce real wage rates, can be attributed to a variety of factors. It has resulted directly from stabilization measures which formed part of the reforms and from a close relationship between fiscal budgets, financial markets, and enterprise organization as described below.

First, fiscal reform consists of an overall cut in subsidies, which means an overall cut in profits and investment finance of state-owned enterprises (SOEs). In view of the significant role played by these SOEs in raising revenues to government budgets under soft-budget constraints, this kind of expenditure cut could sometimes, after all, expand the budget deficit rather than vice versa. On the other hand, time and resources are required to enlarge the tax base and to introduce new tax instruments, especially in transition economies. In addition, structural adjustment requires increasing expenditures on the social safety net, particularly during the transition period. In Eastern Europe it has been said that increased unemployment increases expenditures for social security purposes under their relatively advanced safety net systems.

Second, price liberalization means increases in input prices as well as output prices to existing enterprises. Because of generalized price distortions, this can lead to declines in their profits, thereby reducing output and then employment, particularly in the case of SOEs. Naturally, newly-established private enterprises can occupy an advantageous position. In fact, non-state enterprises, which are generally small- and medium-sized and in labor intensive industries, have shown far better performance than SOEs, both in Eastern Europe and Asia.

Third, monetary tightening implies higher interest rates and a credit crunch. This in turn frustrates financing needs not only for investment, but also for working capital, leading to output reduction. This type of stagflationary impact has been typical of developing economies under 'financial repression' and/or imperfect capital markets, as pointed out by Taylor [1980] and Calvo and Coricelli [1992]. When financial repression is so serious that households or domestic savors have weak financial intermediary links with enterprises or domestic investors, enterprises themselves establish intra-firm networks for claims and liabilities. The stabilization measures then accelerate the accumulation of these claims, thereby undermining the managerial foundation, first of those enterprises, and then of their lending banks, which in turn can shake the stability of the financial system as a whole.

### 3.2 Initial Conditions for Reform Programs

Now, if we turn to the recent economic performance in transition economies, we find a shocking contrast between Eastern Europe/the former Soviet Union and China/Vietnam. While Eastern Europe and Russia have suffered from persistent negative economic growth and inflation, China has realized double-digit growth with limited inflation and Vietnam has also attained fairly steady growth and has, to date, successfully controlled inflation (See Figures 3 and 4).

There are no significant differences between Eastern Europe and China and/or Vietnam as far as the macroeconomic transmission mechanism is concerned. What is the cause, then, of such contrasting results? One probable reason would be a difference in the initial conditions of the recent economic reforms.[4] Three aspects could be essential in explaining this great contrast. They are 1) industrial structures, 2) macroeconomic situations and 3) pre-reform regimes.

*Industrial Structures*

In Eastern Europe, the industrial sector was dominant and agriculture was minor in terms of both output and employment, but this situation was reversed in China and Vietnam (See Figure 5). Given that central planning is more effective in industry than in agriculture, it is not hard to see that the impact of reforms on output and employment would be larger in industrial economies than in agricultural ones.

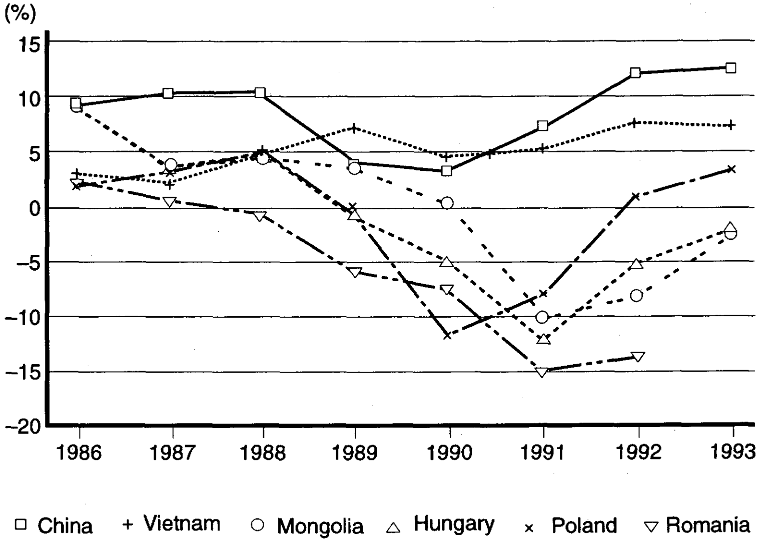
It is known that the large agricultural sector in developing economies can be seen as a reserve of underemployment. The agricultural sector provides burgeoning non-state enterprises with its surplus labor force. This is what happened particularly in China in the case of the well-known township-and-village enterprises (TVEs).

We must emphasize here that the steady growth of the agricultural sector in China played a significant role in providing increasing demand and adequate domestic savings, in addition to a labor force. Note that the increase in domestic savings has been realized with a parallel increase in monetary asset holdings, which must have contributed to domestic investments through financial intermediation. Therefore, growth in agriculture supported not only the supply-side, but also the demand-side of the economy.

*Macroeconomic situations*

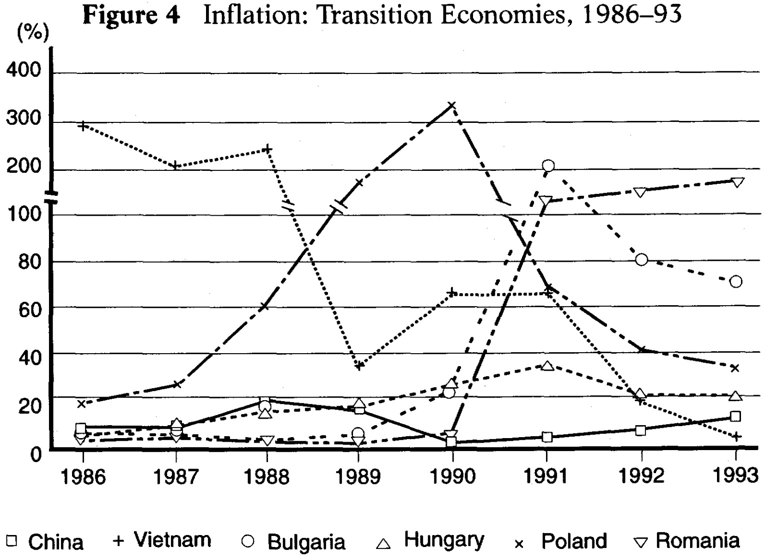
If we focus on recent economic reform efforts in the late 1980s, we find that macroeconomic situations at the start of the reforms were far worse

**Figure 3** GDP Growth: Transition Economies, 1986–93



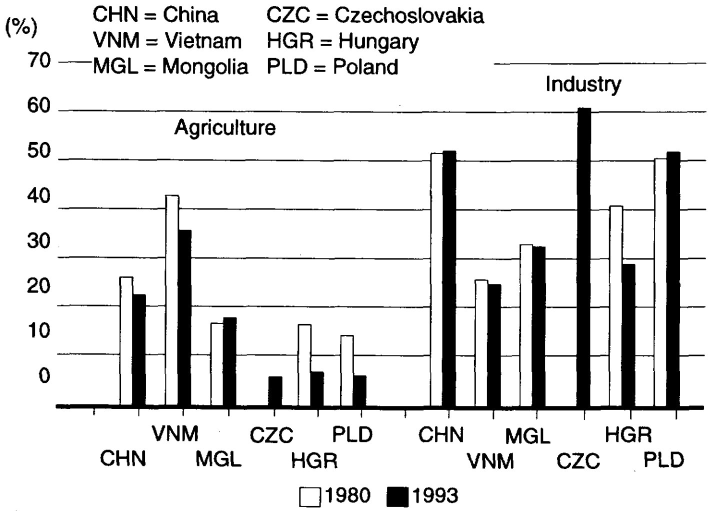

Source: Kohsaka (1994).

**Figure 4** Inflation: Transition Economies, 1986–93




Source: Kohsaka (1994).

**Figure 5** Sectoral Share of GDP: Transition Economies, 1980–93




Source: Kohsaka (1994).

in Eastern Europe than in China. Real growth rates were either stagnant or simply negative, exports were slow, current account deficits were increasing and, consequently, external debt was piling up. China, in contrast, was growing at not remarkable but significantly positive rates, and it was virtually free of external debts.

The heavy external borrowings by countries in Eastern Europe had not only postponed necessary domestic adjustments, but had also accelerated the degree of those adjustments. The international debt crisis then halted the debt flow to developing economies so that they were forced to abruptly cut their domestic consumption levels. This is an additional demand-side factor that could explain the sharp and persistent fall of total output in Eastern Europe.

*Pre-reform regimes*

The degree of the pervasiveness of central planning varied across economies. First, the presence of state-owned enterprises (SOEs) was far more significant in Eastern Europe than in China. SOEs held a greater than 80 percent share of output and employment in the former, but less than 20 percent in the latter (See Table 7). Thus, it is no surprise that the negative impacts of price liberalization, fiscal reforms, and monetary restraints through SOEs must have been relatively larger in Eastern Europe.

**Table 7** Employment by Type of Enterprise: China and Russia, 1978–91

| | China | | | Russia | |
|---|---|---|---|---|---|
| | 1978 | 1984 | 1991 | 1985 | 1991 |
| State owned enterprises | 18.6 | 17.9 | 18.3 | 93.1 | 86.1 |
| Collective enterprises | 72.0 | 67.0 | 63.9 | 6.0 | 5.3 |
| Township-village enterprises | 4.3 | 7.6 | 10.0 | N.A. | N.A. |

Source: Sachs and Woo (1993).

Second, agriculture was decentralized earlier in China than in Eastern Europe so that agricultural development began prior to industrial growth.[5] This made the transition process easier through relatively smooth transfers of resources across sectors.

Third, the share of CMEA trade was explicitly larger in Eastern Europe (and Vietnam) than in China.[6] The collapse of CMEA thus had a more serious negative impact on external trade in the former than in the latter. We must note that this was only a short-run impact effect, similar to terms-of-trade changes, while the CMEA regime itself had a long-term negative effect by misguiding industrial structures based on distorted prices.

## 3.3 Policy Issues for Transition Strategies

In this section, we discuss the role of policy factors in generating the wide range of economic performance seen across transition economies. Initial conditions are not the sole factor to explain the above performance gap. In fact, it is known that policies and/or strategies undertaken in transition economies were diverse in several aspects. We will focus on 1) the pace of reform, 2) the role of government, and 3) regional externalities.

### *The pace of reform*

There has been much debate on whether the 'big bang' approach or the 'shock therapy' is more useful in tackling the difficulties these transition economies confront. This line of argument has much to do with a general issue of the 'sequencing' of economic liberalization policies in developing economies in general.

There seems to be a consensus in the understanding that macroeconomic stabilization through monetary control and fiscal reform should come first and immediately and that domestic financial liberalization should be implemented in a gradual and cautious way. We have not found, however, a consensus on the appropriate pace of trade liberalization. In the case of transition economies, in addition, greater consideration must be given to widespread price distortions as an initial condition, and to far from solid preconditions, such as a lack of rules of the game for economic activities. It would be correct to assert that overly expansionary monetary and fiscal policies can not prevent excessive output declines in the transition process. But it would also be correct to say that it is neither simple nor easy to "get prices right." Particularly if stabilization efforts reduce output and employment, thus magnifying and sustaining risks, the resource costs necessary to normalize a relative price structure may soar.

In other words, structural adjustment in transition economies can be seen as an unprecedented experiment not only to make the market function, but to establish the basic infrastructure to allow the market to function. Accordingly, while we can draw on the experiences of other developing countries, pragmatic and flexible policy management and partial, experimental and step-by-step approaches are required rather than the straightforward application of *standardized* prescriptions. Thus, arguments such as that of 'shock therapy' vs. 'gradualism' may not be of much relevance, since it is neither realistic nor flexible.

### *The role of government*

As for the role of government in the development strategies of developing countries, multilateral institutions - who are bent on market-orientation - have become aware of its positive significance. This is indicated by their shift in policy thinking from the market-oriented to the 'market friendly approach.' The economic role of government in the capitalist economy has been well-articulated.[7] It is to provide basic infrastructure, both tangible and intangible, for building a foundation upon which the market mechanism can function, and to complement the market by supplying a wide spectrum of public goods. We may be able to widen the definition of 'public goods' by including all intangible and tangible goods and services to be provided by government.

If we take this one step further, we can see the market as only one of rules of the game governing economic activities. In this case, the roles of government need not be confined to complementing market forces. Government can be not only a player, but a referee and/or a supervisor stage-managing the process of the game. From this point of view, we can see that the field of government activities can be larger than provision of public goods as defined by microeconomics. Namely, government may provide a wider range of public goods, including tangible and intangible infrastructure which supports the game. According to this broad definition, 1) macroeconomic stability and 2) credibility of a policy framework in fighting against system risks are two of the most important 'public goods' that can only be provided by government. These two public goods are not mutually exclusive, but rather are closely linked to one another.

Macroeconomic stability has become generally accepted as the first priority not only in transition economies. It is a basic precondition for mobilizing domestic savings, and attracting foreign saving, and then boosting domestic investment, thereby sending an economy on a dynamic growth path. If macroeconomic stability does not exist initially, there may be unavoidable adjustment costs involved in regaining it, as is seen in the transition process in Eastern Europe.

However, the costs should be minimized and limited as far as possible to relevant sectors. Structural reforms inevitably require income and/or asset redistribution as well as resource and/or production factor reallocations across various sectors. In China, the agricultural sector has realized steady growth and successfully supported the non-state industrial sector. In contrast, it seems that, in Eastern Europe, non-state sectors have been burdened by adjustment costs incurred by state-owned enterprises. It may be too early, though, to call this observation definite.

Moreover, macroeconomic stability could be regarded as a guarantee of the adequate managerial skills and determined political will of the government. Long-term economic decisions and plans can not be made without credibility of the policy framework or confidence in the continuity of the overall political-economic framework. This is more crucial in transition economies than elsewhere.

The reform experience in China has provided many insights in this respect. Whether good or bad politically, the government has taken a step-by-step approach to go from a centrally planning to a market orientation, so that the short- and, perhaps, medium-term course of events has been relatively more visible to economic agents than in Eastern Europe.

It is sometimes pointed out that China's recent dynamic growth has been accomplished to a significant degree by the non-state sector, so that substantial decentralization was the key factor. This observation does not necessarily contradict the above assertion, but rather strengthens it, because this decentralization reflects a steady reallocation of resources within the above-mentioned policy framework. We must note, however, that this is not to say that the present policy framework will continue to be effective and/or viable in the final stage toward a 'full-fledged' market economy in China.

*Regional externalities*

Finally, more emphasis needs to be placed on the differences in location of the individual transition economies. That is, we must take into account the role of 'regional externalities.' The collapse of the CMEA regime is seen to have had a serious negative impact on those economies which depended on it. While we may call this an external diseconomy due to formal regional disintegration, China as well as Vietnam have enjoyed external economies generated by natural or informal integration through trade and capital flows in the Pacific Asia (See Figure 6).

Before reform, China was not only less dependent on CMEA trade, but also on external trade in general than were Eastern Europe and even Vietnam. During the process of transition, China has undergone an opening up, and its dependence on external trade has increased rapidly, which cannot be seen as independent of the dynamic development of the region as a whole. This is without doubt a good example of a virtuous circle of trade, investment and economic growth. Unfortunately, this sort of environment did not exist in Eastern Europe and the former Soviet Union.

Increased interdependence through trade and capital flows would not only expand available opportunities, but also bring in additional beneficial impacts such as technology transfers, policy management skills, and discipline through international competition. This is generally the point to make in explaining the dynamic growth in the Asia Pacific region as well as in particular the case of China, where several authors have stressed the role of ethnic Chinese communities in the Asian Pacific region in terms of financial, commercial and technical capabilities.

## 4. DEVELOPMENT EXPERIENCES IN EAST ASIA

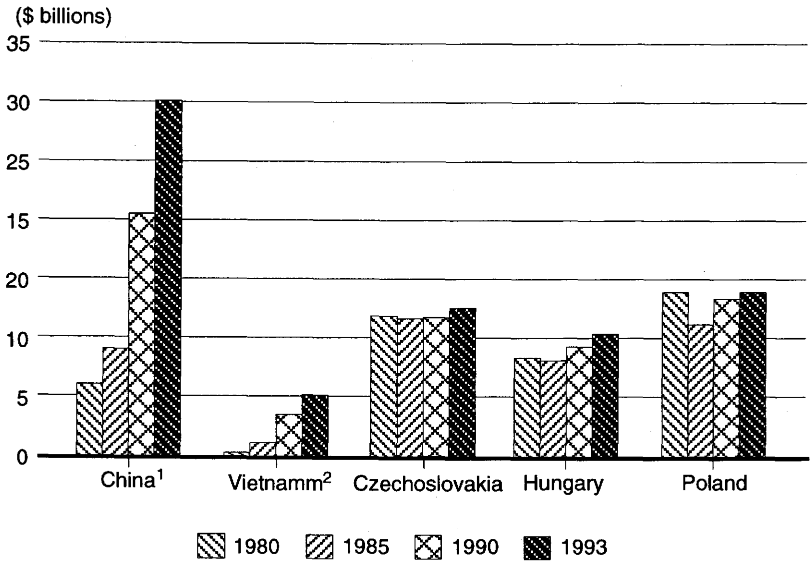
### 4.1 Increasing Interdependence under Rapid Growth

Since the 1980s, East Asia has attained not only sustained high growth, but also remarkably increased economic interdependence, even in the absence of formal agreements on regional integration.

First, intra-regional trade in the Pacific Asia has expanded significantly, amounting to 35 percent of total trade in 1992, compared with 62 percent in the European Union. In particular, intra-regional trade within APEC member countries has exceeded that of the EU in value terms from 1990 onward.

Second, this increasing intra-regional trade, mainly in manufacturing sectors, has involved not just increases in volumes, but also in the sophistication of industrial networks of sourcing, production and mar-

**Figure 6** Merchandise Exports: Transition Economies 1980–93




Notes: 1. Reduced to 1/3
2. Doubled.
Source: Kohsaka (1994).

keting within the region, through intra-industry and/or intra-firm trade. This industrial networking has been accompanied by amazing changes in industrial structures in the region.

Third, the changes in industrial structures can be attributed to a significant degree, again, to increasing intra-regional foreign direct investment in the Pacific Asia. By the 1990s, Asian NIEs turned into net capital exporters. Capital importers appear to have changed over time in a flying-geese pattern, from ANIEs to ASEAN and from ASEAN to China. Table 8 shows that ANIEs accounted for 31 percent of FDI stocks in the Pacific Asia in 1993, as compared to 21 percent for Japan, 14 percent for the U.S. and 12 percent for the EU. And these figures even tend to be understated.

These recent developments are, without doubt, attributed to a combination of external and domestic factors. It seems quite obvious, however, despite the fact that external factors were mostly shared with the other developing countries, we have seen dramatic differences between the Pacific Asia and the other developing regions. It is only natural to ask where this difference comes from.

**Table 8** Foreign Direct Investment to Pacific Asia, 1982–93
(Outstanding stock, % and $ millions)

| from/to | ANIEs | ASEAN4 | China | Asia PECC | LA PECC | LDC PECC | USA | Industrial PECC | PECC Total |
|---|---|---|---|---|---|---|---|---|---|
| U.S.A. | | | | | | | | | |
| 1982 | 32.9 | 11.1 | — | 18.1 | — | — | — | 25.7 | — |
| 1986 | 33.5 | 15.5 | 15.6 | 21.5 | 66.5 | 35.0 | — | 19.0 | 22.1 |
| 1990 | 30.3 | 9.4 | 11.2 | 15.1 | 59.8 | 25.3 | — | 16.4 | 18.4 |
| 1993 | 30.8 | 10.9 | 8.1 | 13.5 | 56.8 | 21.1 | — | 16.9 | 18.3 |
| EC | | | | | | | | | |
| 1982 | 21.9 | 15.5 | — | 17.6 | — | — | 66.7 | 49.1 | — |
| 1986 | 17.9 | 14.5 | 7.2 | 14.8 | 17.6 | 15.6 | 65.4 | 52.4 | 45.1 |
| 1990 | 19.3 | 11.3 | 5.0 | 12.5 | 20.8 | 14.4 | 62.6 | 50.8 | 42.3 |
| 1993 | 19.9 | 13.0 | 3.2 | 12.0 | 20.5 | 13.5 | 60.8 | 48.9 | 37.0 |
| Japan | | | | | | | | | |
| 1982 | 23.8 | 29.8 | — | 27.9 | — | — | 7.8 | 5.9 | — |
| 1986 | 29.5 | 26.3 | 15.1 | 26.0 | 4.9 | 19.7 | 12.2 | 9.7 | 11.7 |
| 1990 | 33.2 | 27.8 | 13.6 | 27.2 | 4.1 | 21.9 | 21.0 | 16.4 | 17.7 |
| 1993 | 31.8 | 21.9 | 8.6 | 20.0 | 3.8 | 17.2 | 21.6 | 16.6 | 16.8 |
| Canada | | | | | | | | | |
| 1982 | 0.1 | 3.1 | — | 2.1 | — | — | 9.4 | 6.0 | — |
| 1986 | 5.1 | 2.7 | — | 3.2 | 1.5 | 2.7 | 9.2 | 6.9 | 6.1 |
| 1990 | 4.8 | 1.0 | — | 1.8 | 1.3 | 1.7 | 7.5 | 5.4 | 4.6 |
| 1993 | 3.8 | 0.5 | — | 1.0 | 3.7 | 1.4 | 8.9 | 6.3 | 4.7 |
| ANIEs | | | | | | | | | |
| 1982 | 3.1 | 11.0 | — | 8.4 | — | — | 0.3 | — | — |
| 1986 | 2.8 | 14.0 | 54.0 | 15.0 | — | — | 0.6 | — | — |
| 1990 | 3.0 | 23.1 | 60.7 | 23.3 | — | — | 0.7 | — | — |
| 1993 | 4.0 | 25.9 | 65.0 | 31.8 | — | — | 1.0 | — | — |
| Total (Million $) | | | | | | | | | |
| 1982 | 10,668 | 22,424 | N.A. | 33,092 | — | — | 124,677 | 204,941 | — |
| 1986 | 18,453 | 30,824 | 6,538 | 55,815 | — | — | 220,414 | 322,843 | 402,580 |
| 1990 | 36,606 | 83,278 | 20,452 | 140,336 | 41,367 | 181,703 | 394,911 | 598,402 | 780,105 |
| 1993 | 50,113 | 158,493 | 64,180 | 283,720 | 60,659 | 344,379 | 445,268 | 685,865 | 1030,244 |
| Ratio of year-end stocks | | | | | | | | | |
| 86/82 | 1.73 | 1.37 | — | 1.69 | — | — | 1.77 | 1.58 | — |
| 90/86 | 1.98 | 2.70 | 3.13 | 2.51 | 1.73 | 2.28 | 1.79 | 1.85 | 1.94 |
| 93/90 | 1.37 | 1.90 | 3.14 | 2.02 | 1.47 | 1.90 | 1.13 | 1.15 | 1.32 |

Note: ANIEs = Hong Kong + Korea + Singapore + Taiwan; ASEAN4 = Indonesia + Malaysia + Philippines + Thailand; Asia PECC = ANIEs + ASEAN4 + China; LA PECC = Chile + Colombia + Mexico + Peru; LDC PECC = Asia PECC + LA PECC; Industrial PECC = Australia + Canada + Japan + U.S.A; PECC Total = LDC PECC + Industrial PECC.

Source: Akira Kohsaka, ed., *Capital Flows in the Pacific Region: Past Trends and Future Prospects*, Japan Committee for Pacific Economic Outlook,1995.

## 4.2 Fundamentals behind the Rapid Growth

*Capital fundamentalism revisited*

It is sometimes pointed out that the economic growth in East Asia has resulted from vigorous capital formation with little productivity growth. Modern economic growth, on the other hand, has been known to be mainly sustained by productivity growth instead of by capital accumulation. How can we interpret these two seemingly conflicting facts?

First, we must recognize that different degrees of economic development exist between the developing economies in East Asia and those developed economies which had already been through modern economic growth. In fact, there is evidence that the lower the income level, the more important the role capital formation plays in economic growth (King and Levine [1994]). Thus we see little anomaly in the dependence of the Pacific Asia on capital formation in its past growth process.

Second, the distinction between contributions by capital formation and by productivity growth is not necessarily unambiguous. Productivity growth is often measured by total factor productivity (TFP). TFP, however, includes everything but factor accumulation. TFP may include exogenous factors such as technological progress, policy changes, institution changes, etc. In particular, if capital formation can have external effects, say, on productivity increases, even it can be covered by TFP.

What matters is not whether the capital fundamentalism is right or wrong, but how we can influence TFP, which is as important as factor accumulation.

*Fundamentals of the East Asian miracle*

The World Bank [1993]'s *East Asian Miracle* identifies such fundamental factors as high factor accumulation, macroeconomic stability, outward-orientation, and policy institutions as important for successful economic development. This publication is an important contribution, but not for pointing to these factors; after all, they were already perceived as crucial in economic development.

Instead, it is important, first, because in it the World Bank, a strongly market-oriented multilateral institution, makes explicit the significance of building and maintaining infrastructure for market mechanisms and recognizes the potential, but indispensable role of government there. Furthermore, the *Miracle* is important because it shows or tries to show that there was no miracle in East Asia. What East Asia did turns out not to be very surprising, because it is more or less along the lines of what the World Bank had been suggesting be done.

### 4.3 Characteristics of Asian Pacific Development

These features of East Asian development are well known and have been frequently discussed. Now, we will focus on relatively neglected aspects of their development experiences.

*No unique pattern in the region*

The diversity of development patterns in the region should be further emphasized. Let us consider two entrepot city economies, Hong Kong and Singapore. They have been very different in various ways, not to mention their development strategies. Korea and Taiwan have contrasted with respect to macroeconomic management, market-government interactions, industrial market structures, etc. This holds true for ASEAN economies as well. East Asia is far from homogeneous. There is no unique development pattern in the region.

*Multiple paths toward market economies*

Hong Kong is unique within the region for its outright market liberalization at the outset of its process of industrialization. Most of the economies have been cautious, in varying degrees, in opening up domestic markets. Some economies seem to have been successful in raising their infant industries into export industries within tariff and/or non-tariff walls.

China's transition to the market economy has attracted wide and deep concern not only among China watchers, but also among outside economists who have been involved, in one way or another, with economic development issues. See, for example, Gelb [1993], Jefferson and Rawski [1994], Murphy et al. [1992], Perkins [1994], Rawski [1994], and Yusuf [1994]. Particularly interesting is the contrast in economic performance between Eastern Europe/Russia and China. The pace of transition in China may be slow, but it seems to be making steady progress. Comparative studies between the two regions appear to suggest that we must learn more about how to build a market system.

Without doubt, the market mechanism can be a driving force for generating economic growth. We must not forget, however, that it would not work without institutional foundations, a set of rules, referees and supervisors, and finally, players' confidence in the whole system. Experiences in industrialization and transition to the market economy in the region urge us to look for multiple paths to economic development.

### *Intra-regional competition and externalities*

It has sometimes been argued that regional integration within ASEAN will be difficult because in terms of external trade their relationship is currently more one of rivalry than of complementarity. We must note here that this rivalry is the source of dynamism in the region. In Pacific Asia, we observe rapid changes in industrial structures, resulting from varying comparative advantages, through harsh competition in intra- and inter-regional trade.

Competition is not only for markets. Even the governments compete for foreign capital, coping with 'regulatory arbitrage.' This actual and potential competition may imply external effects. Asian NIEs have become 'role models' for ASEAN economies, just as Japan was for Asian NIEs. China learned much from the prior industrialization experiences in the region. Vietnam may watch China. One may be able to call this as 'regional externalities.'

## 5. CONCLUDING REMARKS

We have argued that the experiences of structural adjustment in developing economies such as East Asia and Latin America cannot be applied straightforwardly to the transition economies. We have also examined differences in recent economic performance across developing and transition economies, and identified some determinant factors in initial conditions, policy strategies and external environments. What policy implications have we learned?

One simple fact is that successful results have not necessarily been obtained through a complete set of policies. The 'East Asian Miracle' as well as 'partial reforms' in China are good examples. They have shown that, at least up to now, there has been *no unique all-weather or all-purpose policy package for transition* as well as for development in general, whether the 'big bang' or 'gradualism.' Appropriate policy strategies for each individual developing economy depend on initial conditions, policy management, and external environments, at least. Moreover, the relative importance of these external factors will be beyond prior knowledge.

In addition, we must note that ties in East Asia have recently become closer through trade and capital flows, without there existing any institutional arrangement for regional integration. We can call this '*de facto* integration,' as opposed to 'institutional integration.' While the region's driving force and policy discipline have been nurtured and maintained by the multilateral free trade system, this does not necessarily mean that its performance was the result of outright market liberalization or opening-up. We must remember the successful experiences of the region, which have been characterized by dynamic competition among heterogeneous member economies. Within the multilateral trade regime, competition has motivated governments to behave efficiently, while the members have pursued orthodox domestic policies fundamental to development.

## Notes

1. For example, Bruno [1992, p.742] writes, "In that superficial respect the adjustment and structural reform problem of Eastern Europe would seem to be akin to that of other middle-income countries, such as Brazil, Mexico, or Israel;....The delayed effects of some of these shocks are only now being felt in Eastern Europe. .....the distance between the initial point and the desired goal is not only wider but substantially deeper."
2. For instance, see Balassa [1984], Dornbusch [1985] and Sachs [1985]. During 1985-87, Asia and Latin America occupied 34 percent and 29 percent of GDP, 42 percent and 17 percent of exports, and 26 percent and 36 percent of external debt, respectively, among developing countries.
3. The 'output collapse' associated with the transition to a market economy tends to be exaggerated by statistical errors inherent to former centrally-planned economies. For details, see, for example, IMF [1994], Box 12.
4. Generally, in order to identify initial conditions, we must pinpoint the beginning of economic reforms. The transition economies, however, have experienced various reform attempts at various stages. In Eastern Europe, economic reforms were tried at least partially in the 1960s, though without much success. IMF-supported comprehensive reforms toward a market economy were initiated in January 1990 in Poland, and then followed by Czechoslovakia, Hungary, Bulgaria and Romania beginning in 1991.

   Thus, instead of pursuing the exact years of transition attempts, we regard the conditions at the collapse of the CMEA regime as initial, because it is convenient for making a comparative analysis of the recent diverse performances among those economies.
5. Agricultural growth during the period of 1980-92 was 5.4 percent a year in China, whereas it was mostly negative in Eastern Europe. Vietnam showed 4.2 percent annual average growth in agriculture during 1985-90.
6. For instance, the share of CMEA exports in 1990 was as large as from 40 percent for Poland to 69 percent for Bulgaria. It is apparent that the negative impact of the collapse of CMEA and Soviet Union was underestimated, when they started economic reforms for transition.

7. 'Market failures' do not necessarily justify government intervention. Namely, when the market fails, the government may also fail. This means there are adequate interventions and inadequate ones.

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