CHAPTER 6

NATIONAL ECONOMIES UNDER GLOBALIZATION: QUEST FOR NEW DEVELOPMENT STRATEGIES

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1. INTRODUCTION

Since toward the end of the 1980s, especially in the 1990s, the pace of the globalization of the world economy has appeared to be accelerated. International trade has grown twice as fast as the world GDP and international capital flows have accelerated its speed of expansion. Though the Asian economic crisis slowed down this pace, when we look at their recovery processes, this globalization trend seems not to slow down, hardly to reverse.

It would be apparent in view of the crisis that this globalization is a double-edged sword in nature with both their benefits and costs. No doubt, there were *vulnerabilities* in domestic economic structures in the crisis-hit economies in East Asia. So what? They had been there for years. The present crisis would have never happened without structural changes in the international economic environment, especially the globalization.

The globalization has been attained through international cross-border movements of goods and services as well as production factors such as capital, knowledge and labor. One dominant impediment against their movements is regulations controlled by governments in charge of nation states[1]. Recently, we have more often than not heard that reducing government intervention to realize freer good and factor mobility would promote the growth of people's income and enhance their living standards. Is this true?

What kind of impacts would the globalization have on policy management and economic performance of developing economies? Is it equally beneficial to them to have expanded international trade and capital flows? Is the deepening of economic interdependence through increased good and factor movements to help reduce income differentials between the North and the

[1] One of the others is, without doubt, transportation and communication costs needed for cross-border economic activities.

South? And, can the globalized market allocate resources efficiently and enhance the global welfare without intervention by national governments?

The purpose of this paper is to review the outcome of our past development strategies and then to examine possible interactions between the globalization trend and development performances. The paper will not show any new evidence on our concerns, but will traffic-control pros and cons of possible effects of the globalization on global catching-up processes. Finally the paper will touch upon the impact of structural reforms on institutional changes under the globalization.

In the following, we first review the impact of the globalization of the world economy on developing economies. In Section 2, we observe first the effects of cross-border movements of goods and services, capital, labor and knowledge upon economic performances and policy management in developing countries. Next, we view the long-run performance of income levels in developing as well as developed countries. It is ensured that, despite a bulk of postwar development efforts, income differences tend to show a divergence trend not only between the North and the South, but also among developing countries.

Two channels through which the income convergence would work out are discussed in subsequent two sections. The globalization of production networks of multinational enterprises (MNCs, hereafter) is well known to go far beyond national boundaries. In Section 3, discussing its pros and cons to national welfare of developing countries, we examine potential roles of states or governments there. A transfer of knowledge and technology has turned out to be not so easy as had been presumed before, because their acquisition and dissemination need various sorts of institutional infrastructure. In Section 4, we discuss the trend of expanding knowledge differences and public policies to cope with the trend.

Two costs accrued from the globalization are examined in the next two sections. Section 5 discusses necessary government intervention to cope with volatile capital flows under the globalization. The globalization necessitates institutional changes in emerging and other developing countries (Section 6). These institutional changes would be costly and need larger government involvement. Noticing the possible magnification of these market failures by the globalization, we argue that only governments representing national economies could remedy them in Section 7.

2. GLOBALIZATION AND INCOME CONVERGENCE

International movements of goods and services, capital, labor and knowledge are not at all new phenomenon. Toward the end of the twentieth century, however, some argue that these international movements have been acceler-

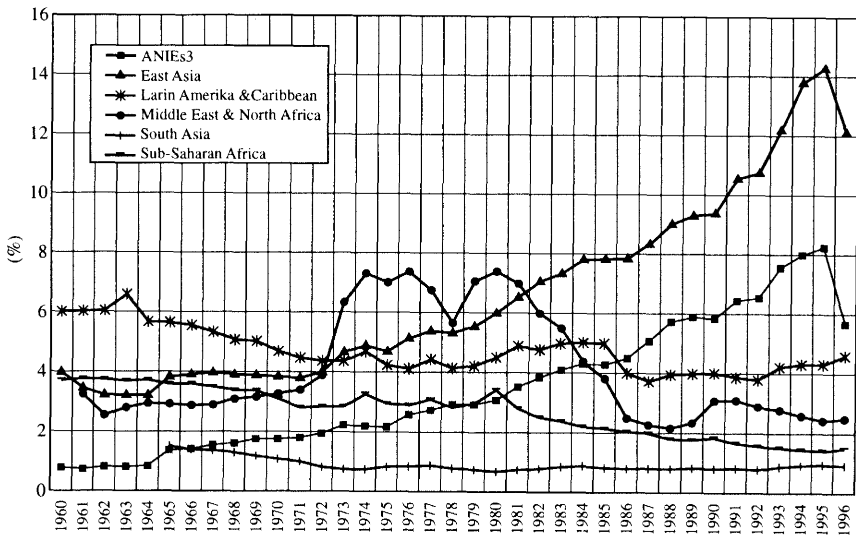
ated and are qualitatively different from those before (Bordo et al. [1998]). It seems that the world economy is going to change from a bunch of autonomous national economies to one large-scale closed economy, where producers and consumers are connected via internet across borders.

When we look back, after World War II, development strategies were formed by governments of newly born nation states. Then, markets were underdeveloped and states were autonomous and strong. Yet, as markets evolved afterwards, the autonomy of governments have become constrained by markets. For example, MNCs decide their locations taking account of differences in taxation and regulation in host countries. These *regulatory arbitrage* behavior of MNCs may determine, or at least, affect government policies to attract foreign capital.

International trade and capital flows have outgrown output, where developing economies as a whole have increased their shares. Furthermore, these economies have deepened and diversified their linkages with the rest of the world through trade flows. With respect to trading partners, a share of trade between developing countries expanded and with respect to composition of trade, a share of manufacturing increased rapidly.

Note, however, that this general trend tends to mask regional differences. Figure 6-1 shows the shares in world trade by region. According to this, it is

Figure 6-1 Export Shares by Region, 1960-96

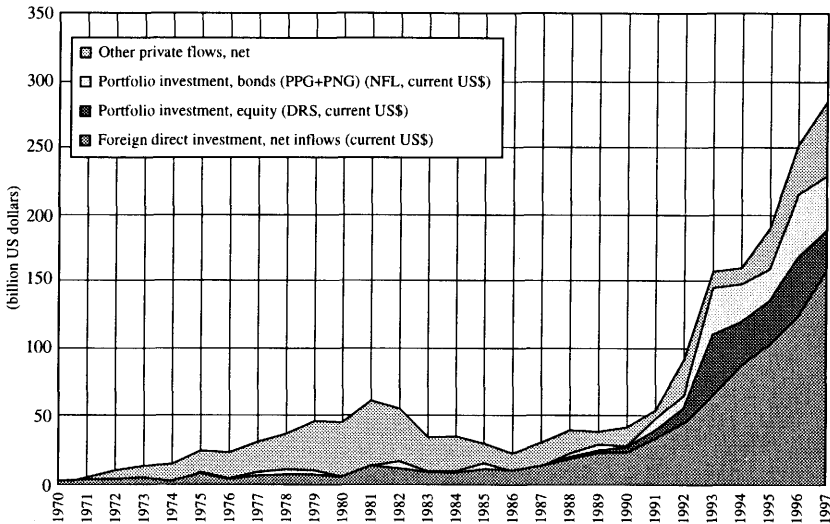


Source: World Bank, *Global Development Finance*, CD-ROM, 2001.

only Asia and part of Latin America which expanded shares and enhanced linkages with international markets. The other regions were slow with this respect.

Also, developing countries have become more and more integrated into the international financial market. We can see the size and composition of capital inflows to developing countries by region in Figure 6-2. Capital inflows to developing countries in 1996 amounted to almost 200 billion dollars, which is six times as large as the average of those in the 1980s and four times as large even as a ratio to GDP. Composition of the flow has changed significantly during the period (see, for example, Kohsaka [1996]). Bank and other loans came first in the 1970s, foreign direct investment has replaced them since the 1980s, and portfolio flows increased weight in the 1990s. Foreign direct investment overwhelmingly has concentrated to emerging markets in Asia and some Latin American countries. Generally speaking, these private capital flows tend to concentrate to rapid growing emerging markets, among which those to Asia was more than ten times as large as those to Africa in dollars and twice as large as a ratio to GDP during the period of 1990 through 1996.

Figure 6-2a Capital Inflows to Developing Economies



Source: Same as Figure 6-1.

Figure 6-2b Capital Inflows to East Asia and the Pacific

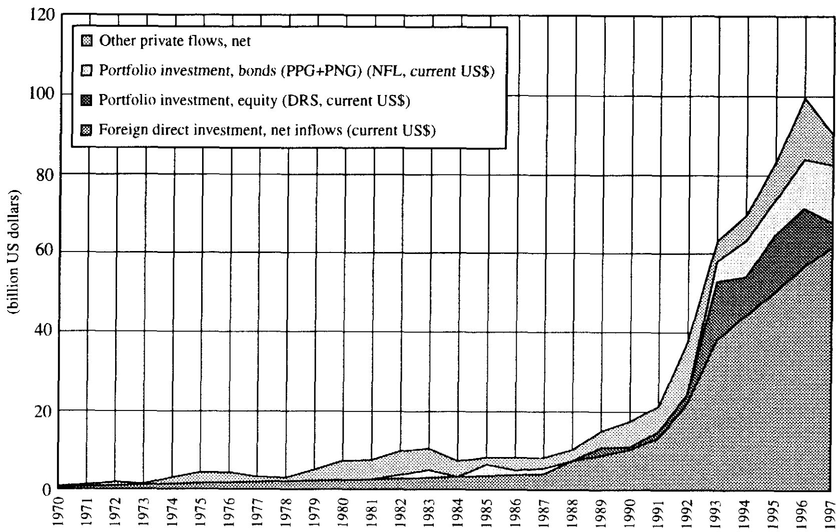


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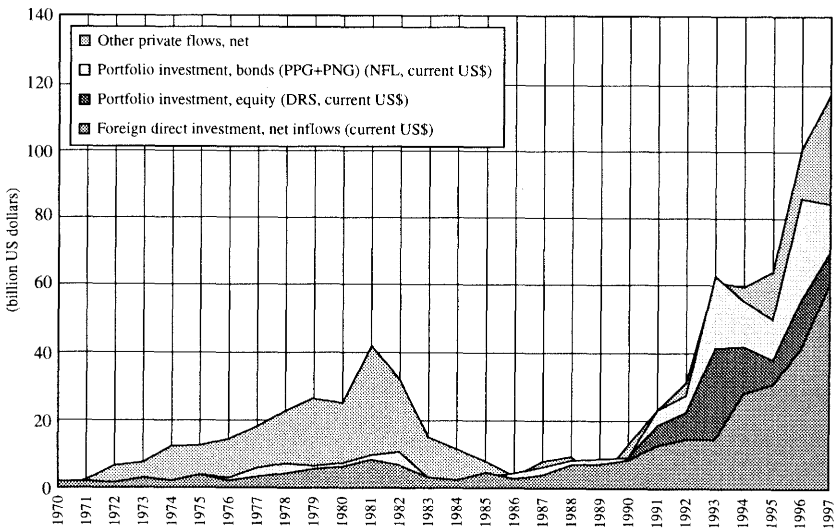
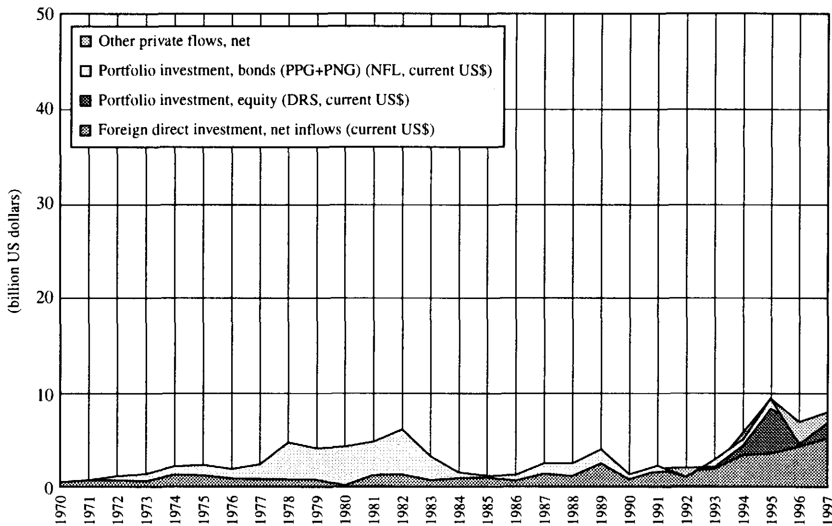
Figure 6-2c Capital Inflows to Latin America



Source: Same as Figure 6-1.

Figure 6-2d Capital Inflows to Sub Sahara

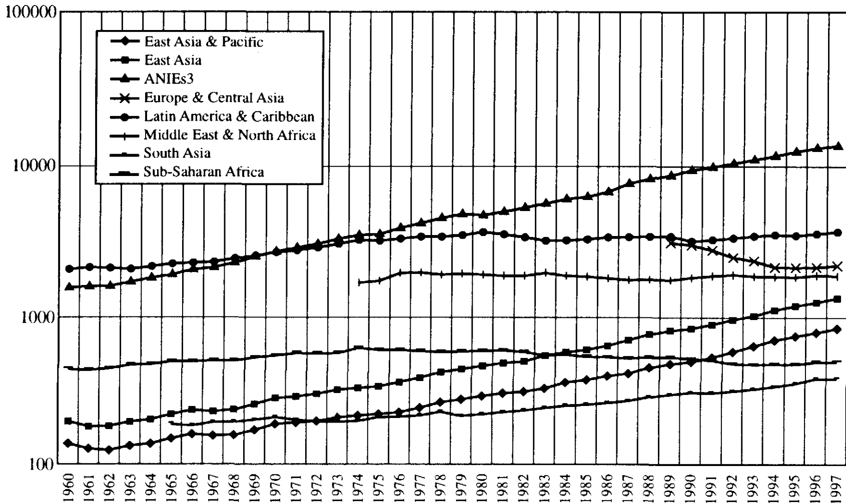


Source: Same as Figure 6-1.

As we have seen, the globalization trend has been pervasive all over the world, but its penetration has not necessarily been uniform across countries. Then, how has the trend affected their overall income levels and economic growth patterns? Figure 6-3 shows per capita income (GDP) levels by region in terms of purchasing power parity (PPP). According to the Figure, developing countries in each region doubled their real income in the past thirty years. That is, in absolute terms, there is no doubt that most of developing countries enhanced their standard of living. Particularly, Asian NIEs (Korea, Taiwan, Hong Kong, Singapore) attained miraculous income growth, while income growth has remained stagnated since the 1980s in Latin America and Africa.

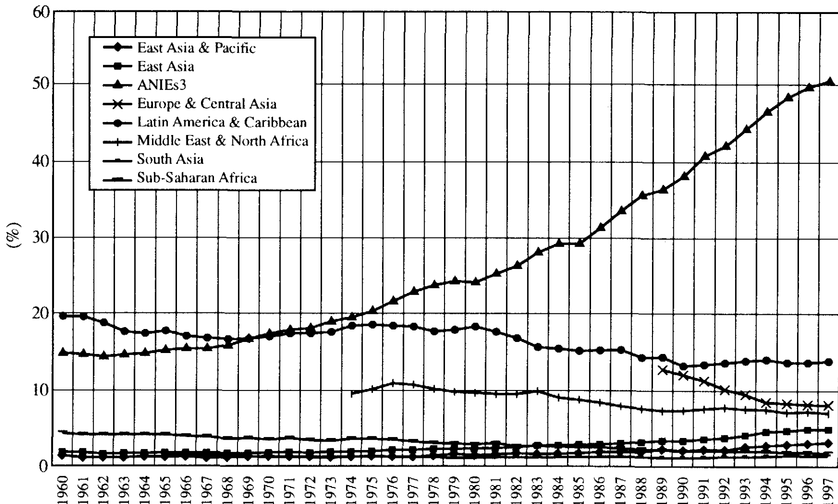
Relative to developed countries, however, most of developing countries obviously failed to reduce income differences. In order to highlight this, relative per capita income levels to developed countries are shown in Figure 6-4. Except for Asian NIEs, only Chile, China, Malaysia and Thailand caught up with developed countries. As a matter of fact, the similar regional pattern can be found in the degrees of integration to the global economy through trade as well as capital flows. In other words, while low-income countries must grow higher than high-income ones for income convergence, there is no such trend in practice. Namely, income differences do not necessarily reduce, i.e. no *absolute income convergence*. Indeed, although East Asia demonstrated that

Figure 6-3 Per Capita Real GDP by Region (1995 dollar constant price)



Source: Same as Figure 6-1.

Figure 6-4 Relative Per Capita Real GDP by Region (Ratio to Per Capita GDP in Developed Countries, 1995 dollar constant price)



Source: Same as Figure 6-1.

a developing country could catch up with developed countries, *the current situation of developing countries clearly suggest that the catch-up is possible, but neither easy nor automatic.*

Obviously, however, we could think of those mechanisms which cause income convergence and the globalization is presumed to reinforce the mechanisms. First, since capital is scarcer, capital-labor ratios are lower and thus expected rates of return of investment are higher in developing countries, increased capital inflows resulting from integration to the international capital market would enhance productivity and economic growth of developing countries. Second, since there is a large knowledge and technology gap between developing and developed countries, increased technology transfers and accompanying spill-over effects resulting from integration to the global market through trade as well as FDI flows would help realize technology catch-up.

Nevertheless, why no income convergence? According to the *new growth theory*, other things being equal, low income countries grow faster than high-income ones (*conditional convergence*). Then, the point is, which things or conditions are not equal and how can we better them? The relevant conditions often pointed out by international cross-section analyses include human capital formation, price distortion, openness of an economy, macroeconomic stability, political as well as social stability and so forth. The theory asserts that the long-run steady state level of income to be converged is not unique and depends on these factors, and that the speed of convergence depends on the difference between this steady state and the initial income levels, that is, the larger the gap, the faster the catch-up. Put this differently, unless these conditions are somehow improved, absolute income convergence could not be realized.

In the following, out of the above two catch-up mechanisms, we discuss the impact of globalized production in the next section and that of technology transfers in Section 5.

3. CATCHING-UP THROUGH GLOBALIZATION OF PRODUCTION?

While MNCs attracted attention in the 1960s as leading world industrialization, it is toward the end of the 1960s when MNCs' subsidiaries started *international vertical division of labor*, or placing more emphasis on intermediate instead of final goods production. At present, the total number of MNCs is said to be around 60,000 in 1998, among whom most of them are located in the United States, Japan and Europe, but some in developing countries such as East Asia and Latin America (UNCTAD [1999]). According to a rough estimation by UNCTAD, the size of MNCs' output amounted to 25 percent of the world output and one third of host countries' output, exceeding that of

Table 6-1 Indicators of International Production

	Value at Current Prices (billion dollars)			Annual Growth Rate (percent)				
Item	1996	1997	1998	1986-90	1991-95	1996	1997	1998
FDI inflows	359	464	644	24.3	19.6	9.1	29.4	38.7
FDI outflows	380	475	649	27.3	15.9	5.9	25.1	36.6
Gross Product of MNCs	2026	2286	2677	16.8	7.3	6.7	12.8	17.1
Total Assets of MNCs	11248	12211	14620	18.5	13.8	8.8	8.6	19.7
Exports of MNCs	1841	2035	2338	13.5	13.1	−5.8	10.5	14.9
GDP at factor cost	29024	29360		12.0	6.4	2.5	1.2	
Exports of Goods and Services	6523	6710	6576	15.0	9.3	5.7	2.9	−2.0

Source: UNCTAD, *World Investment Report*, 1999.

international trade in 1998 (Table 6-1). In terms of stocks, while the majority is services in developed countries, it is manufacturing in developing countries, services increased their presence in both.

Expanding MNC activities are a main cause of the increase in international current transactions. First, external trade related to MNCs reached two thirds of the total, of which intra-firm trade occupied one third. Second, MNC related transactions expanded technology trade through capital good trade, technology license fees, technological training programs, etc., and its growth exceeded that of FDI. Since research and development activities are concentrated in MNC headquarters, the growth of technology trade among developed countries is the largest. Third, as for financial flows accompanying establishment, acquisition and expansion of subsidiaries, i.e. foreign direct investment (FDI), we already touched on part of them in developing countries, although the other part has shown more dynamic growth recently. Summing up, MNCs have played an increasingly significant role in increasing international flows of goods and services, technology and financial resources.

The world FDI increased by 39 percent in 1998, which is record high since 1987. The net increase is due to that between developed countries, and its major part is M&A, presumably driven by urgent needs for expanding sizes and market power in order to cope with intensified competition under the general trend of deregulation and market integration. The globalization has rapidly changed the international economic environment through accelerated technological innovation and shrunk economic space. Then, what does it imply for developing strategies of developing countries? Let us consider this from a viewpoint of dynamic learning effects.

According to the theory of foreign direct investment, MNCs compete with local firms, making use of ownership advantage of their managerial resources as well as of internalization advantage through intra-firm transactions and of location advantage of a host country. Since MNCs could deploy their mobile

resources in a global scale in pursuit for optimal locations, their locational decisions depend on whether host countries could provide with necessary immobile resources or factors. In other words, MNCs tend to utilize *static comparative advantages* of a host country at the moment of their investment decisions.[2]

Then, the issue here is whether such MNCs' behaviors conflict with the benefit of host countries or not. There could be three types of market failures. First, incomplete information may induce inadequate investment. Second, MNCs' private benefits may deviate from host countries' social benefits. Third, MNCs may be stronger in negotiating power than host countries' governments to take a lion's share of benefits from enlarged international division of labor.

The first case occurs when incomplete information induces excessive investment by MNCs and distort factor prices. Then, there may be not only income transfers to MNCs, but also the secondary burden of crowding out of local firms to host countries. Excessive incentives for FDI could have the similar problems.

When learning effects are smaller in MNCs than in local firms, the second case becomes relevant. While FDI is often supposed to be a major channel of technology transfer, this may not always be the case. If we note that internationally extended production networks have brought about meticulous process division of labor, where in fact MNCs tend to lock in the present static comparative advantage of a host country and may retard a change in its dynamic ones.

Examples of the third case are those where rivalry among host countries goes too far to distort factor prices through competitive provision of investment incentives and where transfer pricing of MNCs using market power and internalization advantage generates income transfers out of host countries. In those cases, presence of MNCs obviously results in welfare loss in host countries.

In the process of the globalization of production activities represented by MNCs, firms decide on international locations and division of labor just as in the case of domestic markets. Namely, firms choose a country (a national economy) and not vice versa, so that national borders tend to become more irrelevant to corporate businesses. By contrast, people's or labor movements across borders, particularly those of residence, are quite limited. Emigrants (= population reside outside their birthplace) are estimated to be 130 million

[2] Of course, static comparative advantage is not the sole determinant of MNC location. For example, in the case of FDI in developed countries, MNCs might pursue for technology transfers from host countries, aiming at learning effects. In the case of FDI in developing countries, MNCs might pursue for high potential growth of host countries, aiming at long-run dynamic profits. Note, however, that in either case these long-run dynamic expected returns need to more than compensate short-run static losses due to static comparative disadvantages, if ever.

in the beginning of the twenty first century and its growth rate to be annual 2 percent. Yet, their share in the total population is to be only as small as 2.3 percent, mainly concentrating on North America, Western Europe, Oceania and Middle East. In this sense, compared to goods and services as well as capital, labor or national people can be said to be immobile.

Therefore, in order to maximize national welfare and to attain sustained national income growth, it is necessary to mobilize immobile resources efficiently, to enhance their quality, and then to nurture higher value added sectors using these resources. For these public purposes to be attained, national governments could play a significant role. Basically, they have to develop and manage the system of those institutions such as legal orders and economic rules which constitute the basis of the market mechanism. Then, they have to provide with public goods and services in such fields as industrial infrastructure and human capital formation where market failures are very likely. Particularly in the present context, in order to realize dynamic comparative advantages, national governments must minimize the incompleteness of information with their functions of signaling and insurance and, at times, play the role of a negotiator delegated by national people to cope with market power of MNCs.

4. CATCHING-UP THROUGH GLOBALIZATION OF KNOWLEDGE?

Natural resource endowments are not fundamental to economic development. This is clear because economic development started from overcoming limitations imposed by them and because we have witnessed many countries without rich natural resources to attain remarkable economic development. Economic development depends on the extent to which we can organize and utilize effectively physical as well as human capital in order to maximize output per capital input. And, it is *knowledge* that can improve the quality of capital inputs as well as enhance the efficiency of organizing and utilizing them.

Postwar experiences of industrialization of developed countries suggest that knowledge becomes more important than capital input along with economic development (King and Levine [1994]).[3] Deliberate efforts in education, research and development for technological innovation and application in both individual and corporate levels are sources of productivity growth. The globalization and integration of the world economy would promote these efforts. In fact, for example, output and trade shares of high-technology in-

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[3] At least at the later stage. Historical experiences appear to suggest that capital input is a major driving force in the earlier stage of industrialization. Whether this is a general pattern of economic development or not is debatable and remains to be seen.

Table 6-2 Share of High-Technology Goods in Manufaturing Value Added and Exports in High-Income Economies

(percent)

	Value Added		Exports	
Economy	1970	1994	1970	1993
Australia	8.9	12.2	2.8	10.3
Canada	10.2	12.6	9.0	13.4
France	12.8	18.7	14.0	24.2
Germany	15.3	20.1	15.8	21.4
Japan	16.4	22.2	20.2	36.7
United Kingdom	16.6	22.2	17.1	32.6
United States	18.2	24.2	25.9	37.3

Source: UNCTAD, *World Investment Report*, 1999.

dustries increased without exception during the period of 1970 through 1994 in OECD countries (Table 6-2). In developed countries, more than half of their GDP are goods and services in *knowledge-based* industries. Since the IT revolution accelerates creation of new knowledge, it is said that, without proper investment in knowledge, even developed countries could lose competitiveness and have development stalled.

To individual developing countries, this kind of globalization trend is the reality which, like it or not, they cannot but accept. In order for them to attain development in this new environment, they have to acquire knowledge and enhance their ability to utilize it far more and better than before. Knowledge, however, is different from ordinary goods and services which can be bought at the market. Since knowledge has the nature of public goods such as *non-rivalry* and *non-exclusion*, private markets would not be able to provide its adequate supply. Moreover, while knowledge needs to be disseminated among people to contribute to economic development, its dissemination cannot be automatic and need a variety of institutional infrastructure to facilitate it.

Thus, in order to create and disseminate knowledge, public policies should establish and manage institutions to provide private sectors with adequate incentives. First, protection of intellectual property rights is necessary not only for promoting technology transfer, but for creating local knowledge and adapting foreign technology. Second, human capital formation is indispensable for acquiring and utilizing knowledge. Specifically, here, public policies should play a very significant role not only in primary and secondary, but also in tertiary education in order to maintain the equality of educational opportunities, to reap spill-over effects of education and to compensate for market failures in educational services. Also, in those fields which we can expect large social benefits such as agriculture in developing countries, it would be useful for the public sector to implement by itself and/or support research and development activities.

Since acquiring established technologies is less costly than innovation, developing countries are thought to be able to enjoy the *advantage of backwardness*, which enables their catch-up (income convergence) to developed countries. Indeed, in such fields as public health and agriculture, we have seen significant declines in infant mortality and remarkable increases in grain production through efficient utilization and dissemination of established knowledge. Nevertheless, fact is that knowledge gaps are widening in many fields. Beside, it is very likely that accelerated technological innovation, which drives the globalization, magnifies this widening process. Even developing countries should not only accumulate factor inputs through physical and human investment, but develop adequate abilities to efficiently utilize best-practice knowledge. Because rents from reducing knowledge gaps could be very large. If developing countries stay put on the present static comparative advantage and are slow in doing deliberate efforts to create dynamic advantage, their living standards would decline because technological progress tends to lower returns on unskilled labor.

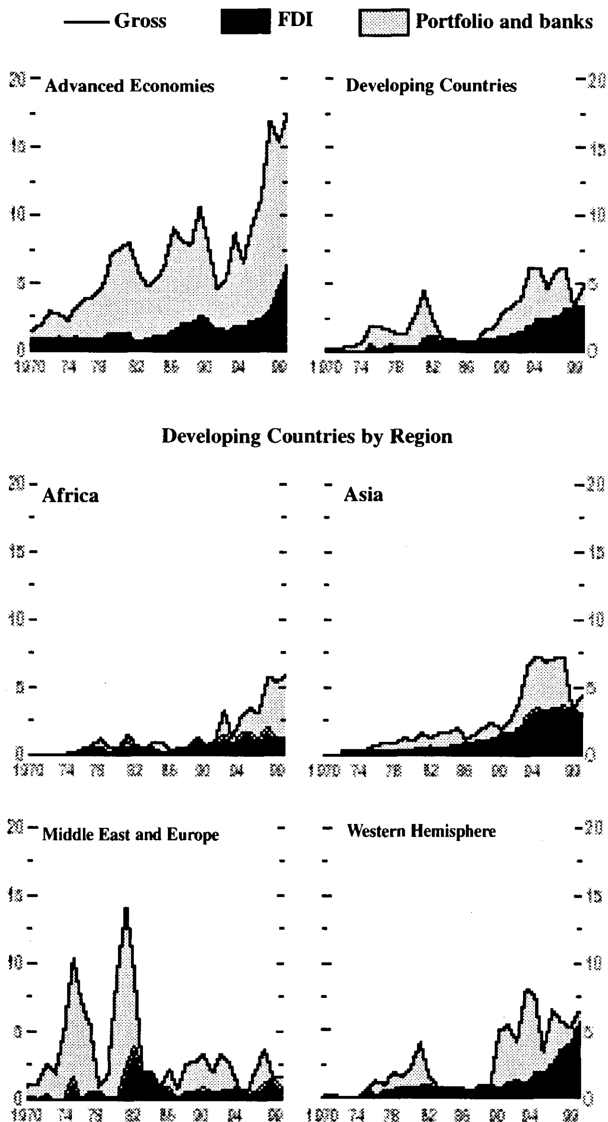
5. COSTS OF GLOBALIZATION: VOLATILE CAPITAL FLOWS

The recent trend of financial globalization has shown us opportunities and risks of capital account liberalization in developing economies. Opportunities include increasing investment possibilities, creating technology spillovers and deepening domestic capital markets. Risks include increasing instability of small open economies exposed more to outside shocks such as sudden reversal of foreign capital flows. Then those economies would face serious difficulties in not only macroeconomic management but also financial systems as a whole.

In fact, these small open developing economies have never been so open as developed economies. Figure 6-5 (the next page) shows the relative size of gross capital flows to GDP across regions. Because of steady increases in foreign direct investment and other capital flows, we can see an enhanced reliance on foreign capital flows of developing economies as a whole. The current situation is, however, not comparable to that of developed economies yet, in terms of levels nor of trends. It is obvious from the Figure that developing economies as well as those in Asia have been far less open than developed economies relative to GDP levels.

Then, how and why less open are developing economies than developed ones? IMF [2001b] shows two complementary measures of capital account liberalization. The *restriction measure* is based on the *number* of restrictions on capital flows as reported to the IMF by national authorities. This measure could not capture degrees of liberalization adequately, though. The other

Figure 6-5 Gross Capital Flows (% of GDP)



Source: IMF, *World Economic Outlook* October 2001, Figure 4.1, p. 147

measure, i.e. the *openness* measure,, is based on gross stocks of foreign assets and liabilities as a ratio to GDP. This is a counterpart concept of domestic financial depth. Degrees of capital account liberalization measured by these two measures are illustrated in Figure 6-6 (the next page).

One notable fact is that, while developed economies show parallel movements in the two measures toward more openness in capital account, both diverged each other over time in developing economies. Particularly in recent periods, the openness continued to be enhanced despite unchanged restriction measures. Particularly in Asia, this must partly reflect the opening up of China and the rapid growth of East Asia.

Moreover, this may suggest either that the restrictions are not necessarily effective or updated, or that the exogenous pressures of capital flows are very strong, or both. Either way this leads to the need for institutional rearrangements and/or catching-up of institutional abilities in capital flow management with the reality of accelerating global financial integration.

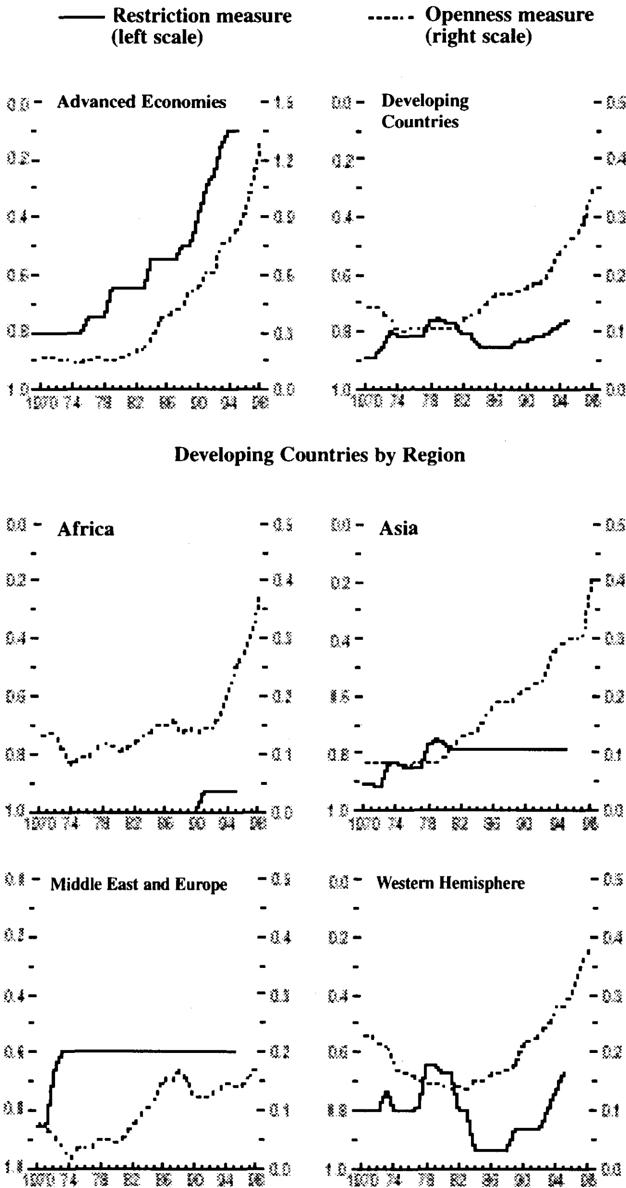
As is always the case, market liberalization per se does not guarantee the market mechanism to fully work it out. This is more so in the case of capital markets, which are characterized with incomplete and asymmetric information problems. Indeed, various studies showed mixed evidences across economies on whether simple capital account liberalization can generate economic growth, either through increased domestic investment, spillovers from technology transfers, or deepened domestic financial markets (IMF [2001b] and the references therein). These results suggest that the impact of capital account liberalization on economic growth appears to be crucially dependent on the initial conditions and policies in our economy in question. In other words, for the liberalization to obtain expected beneficiary results with minimal costs, we are required to improve institutional conditions which may not be able to be spelled out in general contexts.

In the long run, the globalization of financial markets could expand opportunities. They come from more efficient resource allocation and better risk diversification. Emerging markets, however, are only marginal in the global capital market so that they tend to be most vulnerable and exposed to large swings of international investor sentiments, being subject to herd behavior and contagion.

IMF [2001a] pointed out the "on-off" nature of international investors in emerging market financing. This is not news at all, but has been well recognized as intrinsic to the international capital market. Currently, on top of this, "increased asset price volatility in matured markets and the prospects of a slowdown in global growth combined with market turbulence in key emerging markets" would make it difficult for emerging markets including East Asian economies to tap external finance in either portfolio investment or loans as much as in the early 1990s.

The international capital market failure is intrinsic to capital markets in

Figure 6-6 Degrees of Capital Account Liberalization



Source: IMF, *World Economic Outlook* October 2001, Figure 4.2, p. 148

general. In domestic markets, we have devised a variety of safety nets such as from the central bank as the lender of last resort to deposit insurance schemes. Yet, we are not equipped with either kind of safety nets in the international market. Obviously, a systemic risk as in the recent Crisis is out of reach of individual monetary authorities in developing economies. This is one reason why the new international financial architecture is desperately needed.

Of course, short run benefits from bailouts and long run costs and risks of moral hazard come into view when devising any new safety net schemes. Keeping in mind of this tradeoff, however, we must proceed to two fronts, i.e. debt workouts in the short run and crisis minimization in the long run. In the debt workouts, it would be necessary not only to work out debts case by case with some debt relief, but to establish rules for risk sharing between private debtors and creditors. Crisis prevention would need actions in three aspects:

First, comes strengthening supervision with respect to both debtors and creditors, where, considering comparative advantages, international cooperation would be necessary on this front. Second, expanded liquidity provision or stand-by arrangements would be helpful in containing sudden capital reversals, at least, to some extent. Remembering the relatively gradual process of crisis spillovers in the Asian Crisis, the idea of Asian Monetary Fund could have been useful, if timing is right. Third, increasing transparency and enhancing disclosure of private as well as public sectors would be of some use in lessening uncertainties, though we must recognize that the process would take time only hand in hand with institutional evolution of individual economies.[4]

6. COSTS OF GLOBALIZATION: INSTITUTIONAL CHANGES?

Development experiences in the past 50 years indicate that development is far from easy. Among developing regions, it is only East Asia that is catching up with developed countries. For the others, income differences with developed ones have kept on widening. In the 1950s and 60s, development strategies intended to industrialize through trade protection and government intervention because of lost beliefs in the market mechanism, but turned out to be *government failures*. In the 1970s, it became a mainstream development strategy to limit government role in macroeconomic stabilization and public good provisions and to make full use of private markets in other domains. One may call the former *interventionism* and the latter *marketism*. The newer the better?

[4] One might claim the need for establishing a robust credit and risk management "culture" which would take time. Increasing competition with foreign financial institutions might help accelerate the process of changing the "culture."

Look at the only successful experience of East Asia.[5] High investment and saving, high investment in basic education, high openness to the world economy and macroeconomic stability resulted from policy choices favorable and efficient for economic development. As is well known, governments in East Asia had never limited their roles into macroeconomic stability and public good provision, though. They intervened actively in international trade and domestic capital markets, but maybe not deviated very far from market criteria. Good economic performance was a yardstick for legitimacy of national governments as well as one for privilege for strategic sectors and firms. It would not be very wrong to say that not market-based formal, transparent rules, but connection-based informal discretionary rules constituted *institutional infrastructure*.[6]

In this sense, the success of East Asia is not because of marketism. Whether marketism or interventionism is not, however, at issue. What is it, then? Institutional infrastructure is not a product of social welfare maximization, but one resulting from political economic conflicts over allocation of resources in a society. East Asia is no exception in this. Nevertheless, resulting selection of policies did not deviate much far from market criterions, at least in comparison with other developing countries, thus people could supposedly enjoy increasing standards of living and put their trust on the general orientation of policy management. Indeed the ultimate goal of development strategies must be not only to adopt righteous policies, but to create institutional infrastructure to motivate this, which has turned out to be the most difficult challenge.

In the case of East Asia, present institutional infrastructure has been historically formed under the political regime of more or less developmental dictatorship than democracy, where, of course through trials and errors, they have adopted comparatively righteous policies. This is not marketism, but not interventionism neglecting the market mechanism. Although objectives and priorities of development have been different across countries as well as periods, governments have coordinated interests of constituents in national economies, the constituents have minded their own businesses with some trust on governments' management of nation states, total of which has resulted in successful improvement of national welfare. This kind of network of mutual trust is the very basic fundamental for economic development, and who else could provide it but national government?

[5] At least until 1997, but I suppose that it would be difficult to totally deny their experiences to be successful in the past 50 years.

[6] Here, institutions refer to a set of formal and informal rules that govern behaviors of individuals and organizations, and their interactions in the development process. Institutional infrastructure, which supports these institutions, consists of such informal behavioral norms as to reduce transaction costs for coordination and trouble solution, and such formal legal rules as enforcement of contracts, protection of property rights, management of bankruptcy, maintenance of competitiveness, etc.

The Asian economic crisis is said to compel "sea changes" not only in corporate governance, but as far as in social contracts between governments and people governed in East Asia (World Bank [2000]). Indeed, in the post crisis process, East Asia began serious institutional reforms in pursuit for resumption of rapid growth. Their first stage is said to be rewarded by their rapid economic recovery, despite the slow pace of their structural reforms. Is this true? Does the East Asian recovery lead to a new rapid growth based on new institutional infrastructure?

The "East Asian Miracle" is said to have been based on high capital accumulation, continuous educational investment and market-friendly institutional infrastructure (World Bank [1993]). The former two may not be able to support their future growth any more, though, as their economies mature. If this is the case, they must support their growth not by factor accumulation but by enhanced factor productivity growth. Then, what is at issue is how the past and current institutional infrastructure can adapt to the globalization and whether current reform efforts lead to necessary institutional changes to support the productivity growth.

It is ironical that the economic crisis enlarged the role of government, because the recent trend view like the Washington consensus tends to be negative to government intervention in general. As a matter of fact, post-crisis macroeconomic adjustments needed fiscal resources and significant amounts of private debts were succeeded by national governments even without formal government guarantees.

Moreover, bigger governments may be required by the general trend of globalization and market-orientation, and by economic development itself. First, increased risks due to the globalization increase the needs for social safety net. Programs of enhanced public employment, agricultural development, social security funds, and income guarantee mechanisms have begun to settle as a social safety net to protect laborers from the risks. Second, knowledge-economy orientation and accelerated technical progresses require increases in educational expenditure and upgrading of tertiary education. Third, to cope with the globalization and heated international competition, industrial infrastructure such as transportation, communication and urbanization must be strengthened. Economic development itself generates the needs for new public services such as environment preservation and social securities, through increasing income levels, urbanization, enhanced education and aging society.

The current reforms include strengthening regulations and supervisions by government and reforms of formal institutions and rules such as accounting rules and judicial institutions like bankruptcy laws. It is not at all obvious whether these formal reforms would be enforced and/or complied in practice, and whether they could curtail transaction and information costs as compared to previous institutions. Generally it would be unlikely for pre-designed laws

and organizations to be "institutionalized" (i.e. accepted as self-binding rules within a society or a nation state) as they are supposed to (Aoki [2002]). Furthermore, even if it is the case it will take a long time to be institutionalized.[7]

7. A QUEST FOR NEW DEVELOPMENT STRATEGIES

Is the integration of the world economy or the globalization really making these existing nation states and national economies useless? As we have reviewed, MNCs have extended their networks of optimal production location by combining their own advantages with host countries'. To MNCs, national economies are to choose, not to develop. This point is valid not only for real capital. Financial capital would share the point. Either bank loans or portfolio investment, they pick up opportunities with the highest expected rate of return in some risk class at the moment across countries. They never invest in one national economy to increase their expected rates of return in general in the long run.

Even so, if expected rates of return are higher in developing countries with relatively scarce capital, capital would flow according to differences in rates of return from capital abundant to scarce countries, equalizing marginal rates of return. In practice, however, since uncertainties are generally larger in less developed countries with scarcer capital, foreign capital tends to concentrate on only few developing countries, i.e. emerging markets other than developed countries. It contributes to development of host countries if efficiently used, but, if not, it may cause a reversal of capital flows, leading to currency crises. The financial globalization does not necessarily wipe out market failures inherent to capital markets, or rather, may magnify the failures in scale.

Development strategy is meant to nurture national economies and enhance national welfare or national people's standard of living. Then, it is only government of nation states as a delegated agency for national people who could be responsible for them eventually. The financial crisis in 1997, which took place under the financial globalization, revealed the urgent needs for restructuring of domestic capital markets and of systems of regulation and supervision. Truly, the Asian economic crisis is a crisis, *not because of inadequate interventions* by national governments, *but because of lack of their adequate*

[7] World Bank [2000] summarizes the extent of governance of public sector by looking at six indicators, i.e. 1) political freedom and transparency of political decision-making, 2) political instability and violence, 3) government efficiency, 4) regulations, 5) judicial rules and 6) corruption. While quantifying the degree of governance is not necessarily easy or reliable, the result appears interesting. The governance in East Asia is intermediate among developing economies. More generally, the institutional quality in governance positively correlates with the degree of economic development, i.e. per capita income levels.

interventions. To cope with this type of crisis, it is important to establish and strengthen a system of adequate regulations and supervisions by government on the domestic front. One of the other causes of the crisis would be international capital market failure which is reflected in excess inflows of foreign, especially short-term capital, their reversals and the following contagion. This is beyond controls of individual national governments, so that we need international cooperative efforts to restructure international financial arrangements. Of course, international cooperation cannot be executed without supports by governments of nation states.

Almost the same could be applied to technology (or knowledge) transfer to developing countries. If the transfer is promoted by the globalization trend through external trade, foreign direct investment and licensing of technologies, and if the IT revolution facilitates access to global best practice technologies, then, taking advantage of late-comer conditions, developing countries could have rapidly reduced knowledge and technology gaps from developed countries. In practice, however, it is far from easy not only to acquire, but to disseminate knowledge and technology. Acquiring knowledge needs historical accumulation of knowledge capital (i.e. large scale fixed capital) in nation states, and protection of intellectual property rights, which motivate knowledge creation, tends to make knowledge acquirement more costly. Knowledge transfer and its efficient dissemination need institutional infrastructure which developing countries are hardly equipped with. Accordingly, acceleration of technological innovation under the globalization is likely to magnify these failures in knowledge markets.

To cope with this, national strategies would be required in view of the public good nature of knowledge. There would be no way but to create dynamic comparative advantage through deliberate and efficient public investment in order to shrink the knowledge gap. Acquiring global knowledge and its localization, and facilitating these through investment in human capital and technologies are only part of responsibilities of national governments.

We have become well aware that economic development needs not only capital and labor, but institutional infrastructure as fundamentals. So far, at least, a unit for the institutional infrastructure has been a nation state, and its establishment, maintenance and management have been the responsibility of national governments. Because, the modern market system could not exist in vacancy or anarchy without government. Namely, it is difficult for any other entity than nation states to enforce individual property rights, contract rules and other basic rules, and to penalize non-compliance against them. Nevertheless, the collapse of socialist planned economies and the stalemate of capitalist welfare states revealed that nation states, if neglect the market mechanism, could fail to improve national welfare and even maintain national economies.

Having realized this, however, it would be too early to jump at the conclu-

sion that we need the market, but not the state any more, or that national economies are not relevant unit for people's welfare any longer.[8] Why? First, welfare states were born, because the market could not well attain distributional equity and adequate public good provision. Second, as demonstrated by some marginalized economies, the loss of state function led to the collapse of national economies, deteriorating severely people's welfare. Even in the capitalist system, the market mechanism does not work without people's trust in the system. The fact that the market mechanism is based on anonymity using price signals, which save information costs cannot deny the importance of trust in the system. While it is true that those rules which constitute institutional infrastructure are to coordinate egoistic interests, we should note that egoistic motivation in a broader sense could be even altruistic. Indeed, nowadays income redistribution and social security systems have been institutionalized, which suggests without doubt that not only egoism, but also humanistic dreams and idealism do drive the system working.[9]

Along with integration of the world economy, the market mechanism would work across borders. This trend would, without impediments against the market, equalize opportunities of people and help poor people in capital and technology stocks catch up with rich one. If that is the case, the globalization would substitute some function of national government and the role of nation state would dwindle. But, since it takes time for capital as well as knowledge and technology to build up themselves, uncertainties and asymmetric information problems are unavoidable, so that their allocation and accumulation tend to be inadequate. Hence, there is reason why governments directly provide with these factors and/or indirectly minimize problems of uncertainties and incomplete information through risk sharing and information provisions, but little reason why the globalization substitutes governments' roles.

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[8] The rationales of mixed economies and welfare states in the capitalist world of the post WWII were criticized harshly by liberalization policy thinking, which started from doubts against the effectiveness of Keynesian-type discretionary policies. One economist put, "One century ago, international trade was completely free and they had never heard of welfare states (Dornbusch [1997])." According to him, "the concept of a state is so obsolete that a nation state cannot be a legitimate unit of economic framework anymore." He may go further to say that, since states began to intervene in economies in the twentieth century, the good, old days in the nineteenth century had gone and a phantom of a welfare state was born.

[9] In the socialist economies, by the end of the 1970s, the failure of centrally planned economies became apparent despite of economic reforms within the regime, and their economic regimes collapsed with the collapse of their political counterparts. Asserting the superiority of the capitalist system based on the market mechanism, another economist states, "while the socialist system would not work without people's trust in it, the capitalist system works even without the trust. There, in the long run, neither dreams nor idealism, but only people's egoism drives the system working (Krugman [1997])." As such, the failure of state-led economic management gave a boost for liberalization-lines of thinking pursuing for small governments.

Furthermore, the globalization could exacerbate market failures by magnifying uncertainties and incomplete information, as in the case of the Asian economic crisis in 1997. For, technological innovation, a driving force of the globalization, has in itself external effects with economies of scale and agglomeration. If such cumulative effects *marginalize* some developing countries, national welfare would decline and income differences would widen further. Then, the burden of minimizing these negative externalities can be partly imposed on national governments on the one hand, but it can better be coped with collectively through international cooperation on the other. Without doubt, only national governments could constitute this kind of collective action scheme.

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